No. 06-1509
Title: Michael H. Boulware, Petitioner
v.
United States
Docketed: May 15, 2007
Lower Ct: United States Court of Appeals for the Ninth Circuit
Case Nos.: (05-10752)
Decision Date: December 13, 2006
Rehearing Denied: April 23, 2007
Questions Presented

~~Date~~~	~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~
May 11 2007	Petition for a writ of certiorari filed. (Response due June 14, 2007)
Jun 6 2007	Order extending time to file response to petition to and including July 16, 2007.
Jul 16 2007	Brief of respondent United States in opposition filed.
Jul 25 2007	Reply of petitioner Michael H. Boulware filed.
Aug 1 2007	DISTRIBUTED for Conference of September 24, 2007.
Sep 25 2007	Petition GRANTED limited to the following Question: "Whether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a non-taxable return of capital up to the shareholder's stock basis, see 26 U.S.C. 301(c)(2), even if the diversion was not intended as a return of capital." The brief of petitioner is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Monday, November 5, 2007. The brief of respondent is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Monday, December 3, 2007. A reply brief, if any, is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Friday, December 28, 2007. Briefs of amici curiae are to be filed with the Clerk and served upon counsel for the parties on or before 2 p.m., 7 days after the brief for the party supported is filed, or if in support of neither party, within 7 days after the petitioner's brief is filed.
Nov 5 2007	Joint appendix filed. (Statement of costs filed)
Nov 5 2007	Brief of petitioner Michael H. Boulware filed.
Nov 13 2007	Brief amicus curiae of National Association of Criminal Defense Lawyers filed.
Nov 16 2007	SET FOR ARGUMENT ON Tuesday, January 8, 2008.
Dec 3 2007	Record received from the U.S.C.A. for the 9th Circuit. (1 envelope)
Dec 3 2007	Brief of respondent United States filed.
Dec 6 2007	CIRCULATED.
Dec 6 2007	Record received from the U.S.D.C. for the District of Hawaii. (5 boxes)
Dec 21 2007	Reply of petitioner Michael H. Boulware filed. (Distributed)
Jan 8 2008	Argued. For petitioner: John D. Cline, San Francisco, Cal. For respondent: Deanne E. Maynard, Assistant to the Solicitor General, Department of Justice, Washington, D.C.

55

Supreme Court, U.S.
FILED

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No.

IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL H. BOULWARE,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. What effect must a federal court give a final, non-collusive state court judgment adjudicating ownership of property in determining a taxpayer's federal income tax liability arising from that property?

2. Whether a taxpayer who seeks to invoke the return of capital rule in a criminal tax case must show a contemporaneous intent to treat the corporate distribution as a return of capital?

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PETITION FOR A WRIT OF CERTIORARI

Michael Boulware petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1-14) is reported at 470 F.3d 931. The court of appeals' order denying Boulware's petition for rehearing (App. 63) is unreported. The district court's jury instructions and oral rulings (App. 15-26) are unreported. The court of appeals' ruling on Boulware's first appeal (App. 27-62) is reported at 384 F.3d 794.

JURISDICTION

The court of appeals entered judgment on December 13, 2006. App. 1. The court denied a timely petition for rehearing on April 23, 2007. App. 63. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 301 of Title 26, United States Code, provides in relevant part:

> (a) In general. Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . . .

(c) Amount taxable. In the case of a distribution to which subsection (a) applies--

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.

(A) In general. . . . [T]hat portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

. . . .

Section 316 of Title 26, United States Code, provides in relevant part:

(a) General rule. For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders--

(1) out of its earnings and profits accumulated after February 28, 1913 . . . .

. . . .

> Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

STATEMENT OF THE CASE

Petitioner Michael Boulware founded Hawaiian Isles Enterprises ("HIE") in the 1980s and served as chairman and president of the company. HIE and its subsidiaries sell coffee, bottled water, and other products. At all relevant times, Boulware owned a substantial portion of the HIE stock.

Over a period of years beginning in 1987, Boulware transferred approximately $4.5 million from HIE to his girlfriend, Jin Sook Lee. In 1994, Lee sued Boulware and HIE in Hawaii state court, claiming that they had improperly obtained money and property from her. Boulware and HIE counterclaimed, seeking a declaration that Lee did not receive the $4.5 million from Boulware as a gift and a judgment that she held the money in constructive trust for HIE. App. 33-36. After a trial on the merits, the jury found that the monies were not gifts and belonged to HIE. App. 35-36. Similarly, "in deciding the equitable issues of unjust enrichment and constructive trust, the state court judge found by clear and convincing evidence that the monies were not gifts to Lee." App. 36. The state judge also found that the $4.5 million "[is] the property of [HIE] which has been and

is being held in constructive trust by [Lee] . . . ." App. 36 (quoting state court judgment).

In 2001, the government obtained an indictment against Boulware, charging him with tax evasion and tax perjury. *See* 26 U.S.C. §§ 7201, 7206(2).[1] The tax counts alleged that Boulware failed to report as income approximately $10 million that he allegedly diverted from HIE, including the $4.5 million at issue in the state court counterclaim. ER 23, 521.[2] The government contended at trial that Boulware had converted the $4.5 million that he transferred to Jin Sook Lee and that the money thus constituted income to him. Boulware countered that the funds belonged at all times to HIE and that Lee had received the money to hold in trust for the company. To support this position, Boulware sought to use the state court judgment establishing that the funds belonged to HIE. The district court refused to give the judgment binding effect and excluded it from evidence.

Following a guilty verdict, a panel of the Ninth Circuit reversed Boulware's conviction. The court held that the district court erred in excluding the state court judgment. App. 33-52. Although the court of appeals reversed Boulware's tax convictions on this basis, it declined to give binding effect to the Hawaii court's determination that the $4.5 million belonged to HIE, because (according to the court) "the ownership of the money as between Boulware and HIE does not appear to have been subject to adversarial testing." App. 42.

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[1] The indictment also charged Boulware with making false statements to a federally insured financial institution and conspiracy to make false statements. Those charges are not at issue here.

[2] The Excerpts of Record from the court of appeals are cited as "ER." The Appendix to this petition is cited as "App."

At the retrial, the district court admitted the Hawaii judgment into evidence. The court instructed the jury that "[t]he state court judgment received into evidence determined that the money that the defendant transferred to his girlfriend, Jin Sook Lee, was not a gift, and remained the property of Hawaiian Isles Enterprises." App. 25. But the court added, over Boulware's objection, ER 807-09, that "[t]hat determination is not binding on you," App. 25. The instruction thus left the jury free to disregard the state court judgment that $4.5 million of the funds at issue belonged to HIE. The government emphasized this point in its rebuttal argument; it told the jury that the state court judgment "doesn't determine anything at all for you, ladies and gentlemen." Tr., Vol. 10, at 200.

As part of his defense at the retrial, Boulware sought to negate the "tax deficiency" and false statement elements of the tax evasion and tax perjury charges by presenting evidence that the money he received from HIE constituted nontaxable returns of capital he had invested in the company. ER 259, 369, 372, 540-48, 608, 629-30. Citing *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976), the district court concluded that, to obtain admission of the evidence, Boulware had to show that the corporate distributions were intended as returns of capital at the time they were made. Because Boulware could not make this showing, the court precluded his evidence and refused to give a return of capital jury instruction. *E.g.*, App. 16-18, 21-23.

The jury found Boulware guilty. The district court sentenced him to 60 months incarceration. He appealed.

On December 13, 2006, the court of appeals affirmed Boulware's conviction and sentence. Because Boulware's proffered evidence in support of his return of capital defense did not satisfy the *Miller* contemporaneous intent

requirement, the court concluded that the district court did not err in excluding that evidence and in refusing to instruct on the defense. App. 3-6. The court recognized that under *Miller* the return of capital rule applies differently in criminal cases than in civil cases. It also acknowledged that its approach conflicts with decisions from the Second Circuit. App. 5-6. Concurring, Judge Thomas observed that if the panel were "writing on a clean slate, rather than under the controlling precedent of [*Miller*], I would adopt the approach of the Second Circuit concerning the return to capital defense." App. 13.

The court of appeals also reaffirmed its view that the state court judgment that the $4.5 million belonged to HIE was not entitled to binding effect and thus that the district court's instruction on the judgment was not error. App. 11-12. The court denied a timely petition for rehearing en banc on April 23, 2007. App. 63.

REASONS FOR GRANTING THE WRIT

The Court should grant the writ to resolve two unsettled issues that are critical to the administration of the tax laws, particularly in criminal cases: (1) the effect of a final, non-collusive state court judgment adjudicating ownership of property on the determination of a taxpayer's income tax liability for that property, and (2) whether a taxpayer who seeks to invoke the return of capital rule in a criminal tax case must show a contemporaneous intent to treat the corporate distribution at issue as a return of capital, as the Ninth Circuit held here and in *Miller*, or merely meet the statutory requirements under 26 U.S.C. §§ 301 and 316, which do not include contemporaneous intent, as the Second Circuit holds.

I. THE COURT SHOULD GRANT THE WRIT TO CLARIFY THE EFFECT OF STATE COURT JUDGMENTS IN FEDERAL TAX CONTROVERSIES.

This Court has held that "federal income tax liability follows ownership," and "[i]n the determination of ownership, state law controls." *United States v. Mitchell*, 403 U.S. 190, 197 (1971); *see also, e.g., United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985) (noting that "state law controls in determining the nature of the legal interest which the taxpayer had in the property"); *Aquilino v. United States*, 363 U.S. 509, 512-13 (1960) (in determining whether a taxpayer had property or right to property to which federal tax lien could attach, a federal court "must look to state law, for it has long been the rule that in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property . . . sought to be reached by the statute") (quotation omitted).

Although these cases establish that state *law* controls the determination of ownership in federal tax cases, the effect of state court *judgments* is less clear. This Court has left no doubt that a federal court deciding a tax case must give controlling effect to a decision of the highest court of a state resolving the property rights at issue. *See Commissioner v. Bosch*, 387 U.S. 456, 465 (1967). But the effect of a decision by a lower state court is unclear. In *Blair v. Commissioner*, 300 U.S. 5 (1937), the Court declared that a ruling by an intermediate state appellate court on issues relating to a trust "is final" in a federal tax case. *Id.* at 8-9. And in *Freuler v. Commissioner*, 291 U.S. 35 (1934), the Court found that the decision of a state trial court, "until reversed or overruled, establishes the law of California respecting distribution of the trust estate. It is none the less a

declaration of the law of the State because not based on a statute, or earlier decisions. The rights of the beneficiaries are property rights and the court has adjudicated them." *Id.* at 45.

These cases seem to give decisive effect for federal tax purposes to non-collusive state court judgments adjudicating rights in property. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), however, clouds the picture. Although *Bosch* affords decisive effect to rulings of a state's *highest* court, it declares that federal courts should merely give "proper regard" to decisions of *lower* state courts. *Id.* at 464-65. The Court oberved that "if there be no decision by [the state's highest court] then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court." *Id.* at 465.[3] *Bosch* did not explain how much deference, if any, "proper regard" for a lower state court decision entails.

Bosch appears to turn on the legislative history of the estate tax provision at issue and to be limited to that specific context. *See id.* at 464. Nevertheless, the lower federal courts have expressed uncertainty about how broadly its rule sweeps. The Fifth Circuit, for example, observed that "[t]he precise scope and meaning of *Bosch* as applied in dissimilar contexts is difficult for us to ascertain." *Estate of Warren v.*

[3] Somewhat inexplicably, *Bosch* observed: "It may be claimed that *Blair v. Commissioner*, 300 U.S. 5 (1937), dealt with the problem presently before us but that case involved the question of the effect of a property right determination by a state appellate court." *Bosch*, 387 U.S. at 462 n.3. But *Blair* involved a decision by the Appellate Court of Illinois--an intermediate appellate court, below the Illinois Supreme Court--and the decree in the case was entered, under mandate from the Appellate Court, by a state trial court. *See Blair*, 300 U.S. at 8-10. Thus, *Bosch* and *Blair* appear to conflict.

Commissioner, 981 F.2d 776, 781 (5th Cir. 1993); *see, e.g., Estate of Delaune v. United States*, 143 F.3d 995, 1001 (5th Cir. 1998) (referring to the "rather ambivalent majority opinion in *Bosch*"). Similarly, the Ninth Circuit, in deciding Boulware's first appeal, noted that "[w]hat effect, if any, *Bosch* has outside the context of the estate tax statute is unclear." App. 40.

This case provides an opportunity for the Court to clarify the scope of *Bosch*. As noted above, "federal income tax liability follows ownership," and "[i]n the determination of ownership, state law controls." *Mitchell*, 403 U.S. at 197. Here, a final state court judgment, obtained through an adversarial, non-collusive trial, squarely determined that HIE owned money that the government claimed Boulware should have reported as personal income. If *Freuler* and *Blair* control, the state judgment precludes prosecution of Boulware for failing to pay taxes on the money and to report it as income. If *Bosch* controls, by contrast, the judgment is entitled only to "proper regard," whatever that phrase may be determined to mean. The Court should resolve the tension between these two lines of cases.

The Ninth Circuit rested its refusal to give the state court judgment conclusive effect on its observation that "the ownership of the money as between Boulware and HIE does not appear to have been subject to adversarial testing." App. 42. But this rationale raises further unresolved questions under *Freuler*, *Blair*, and *Bosch*. As the Fifth Circuit has noted, federal courts have given controlling effect in some settings even to "bona fide settlements of adversarial litigation not instituted for tax purposes." *Estate of Warren*, 981 F.2d at 781. It is hard to see why the fully litigated judgment in the state court action among Boulware, HIE, and Lee should receive any less effect than a settlement, even if

Boulware and HIE did not expressly litigate the ownership of the funds as between each other.

Moreover, the court of appeals ignores the significance of Hawaii principles of claim preclusion. Boulware and HIE were both parties to the state court proceeding. Under Hawaii law, "the judgment of a court of competent jurisdiction is a bar to a new action in any court between the same parties or their privies concerning the same subject matter, and precludes the relitigation, not only of the issues which were actually litigated in the first action, *but also of all grounds of claim and defense which might have been properly litigated in the first action but were not litigated or decided.*" *Bremer v. Weeks*, 85 P.3d 150, 160 (Haw. 2004) (emphasis added); *see, e.g., Foytik v. Chandler*, 966 P.2d 619, 626 (Haw. 1998) (same). Because any claim of ownership Boulware had against HIE concerning the $4.5 million "might have been properly litigated" in the state court action with HIE and Lee, Boulware cannot challenge the judgment that the money belongs to HIE. The judgment in favor of HIE thus conclusively determines the property rights in the $4.5 million not only between HIE and Lee, but also between HIE and Boulware. Just as Boulware cannot obtain the benefits of HIE's $4.5 million, he should not be held responsible, criminally or civilly, for not paying federal income tax on that money.

Even if the Court were to agree with the court of appeals that *Bosch* controls under these circumstances, rather than *Frueler* and *Blair*, it should clarify the "proper regard" that the federal court must show to the lower state court judgment. The district court's instructions simply told the jury that the state court determination that the funds remained the property of HIE "is not binding on you." App. 25. The instruction did not require the jury to give "proper regard" to the state judgment, much less explain how much

deference the "proper regard" standard mandates. Nor did either the district court or the court of appeals perform the task that *Bosch* appears to contemplate: to "sit[] as a state court" and predict how the Hawaii Supreme Court would decide the ownership issue under state law. 387 U.S. at 465.

II. THE COURT SHOULD GRANT THE WRIT TO RESOLVE THE SPLIT IN THE CIRCUITS OVER THE RETURN OF CAPITAL RULE.

The Court should also grant the writ to resolve the split between the Second and Ninth Circuits over the application of the return of capital rule in criminal cases.

As the court of appeals recognized, "an essential element of the crime of tax evasion is the existence of a tax deficiency." App. 3. To prove the tax evasion charges, therefore, the government had to establish that Boulware owed taxes based on income he failed to report. Similarly, to prove the tax perjury charges, the government had to show that Boulware falsely understated his income. App. 53. Under the government's theory, the unreported income at issue on all counts consisted of money Boulware obtained from HIE. *E.g.*, ER 495-520.

To negate the "tax deficiency" and false statement elements of the charges, Boulware sought to establish that the money he received from HIE constituted returns of the capital he had infused into the company. When a corporation without earnings or profits distributes funds to a shareholder, the distribution is a nontaxable return of capital, up to the shareholder's basis in his stock. *See, e.g., United States v. Bok*, 156 F.3d 157, 162 (2d Cir. 1998); *United States v. D'Agostino*, 145 F.3d 69, 72-73 (2d Cir. 1998). The United States Tax Court recognized this principle in *Truesdell v. Commissioner*, 89 T.C. 1280, 1294-95 (1987).

The return of capital rule follows directly from the relevant provisions of the Internal Revenue Code. Section 301(a) of Title 26 declares that distributions by a corporation to a shareholder with respect to its stock "*shall*" be treated as provided in § 301(c), with exceptions not applicable here. 26 U.S.C. § 301(a) (emphasis added). Section 301(c) divides corporate distributions into dividends (as defined in 26 U.S.C. § 316), which are taxable as ordinary income, and non-dividends, which are taxable as capital gains to the extent they exceed the taxpayer's basis in his stock but are otherwise nontaxable. 26 U.S.C. § 301(c). Section 316 defines dividends as any distribution by a corporation to a shareholder "out of its earnings and profits." 26 U.S.C. § 316. Read together, these statutes establish that when a corporation without earnings or profits distributes funds to a shareholder up to the shareholder's basis in his stock, the distribution is a nontaxable return of capital. *See Bok*, 156 F.3d at 162.

In accordance with this rule, Boulware proffered expert and lay testimony that for the years at issue HIE had no earnings or profits and the money Boulware received constituted a nontaxable return of capital. *E.g.*, ER 369, 372, 540-48, 608, 629-30. Boulware also requested a return of capital jury instruction that correctly stated the principles outlined above. ER 259.

The district court prohibited Boulware from presenting evidence to support his return of capital defense. Relying on *Miller*, the court declared that "[t]he defendant must not show merely that the funds could have been a return of capital; he must introduce evidence showing that, at the time of the transfer, the funds were, in fact, a return of capital." App. 21; *see* App. 18 ("[I]f the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions were intended to be a

return of capital."). Thus, the court required a showing of intent on the part of Boulware or HIE *at the time of the distributions* to treat them as returns of capital. Because the court found that Boulware's proffer did not meet this contemporaneous intent standard, it barred him from presenting any supporting evidence, *e.g.*, App. 21-23; ER 746, and it refused to instruct the jury on the return of capital defense.

The court of appeals affirmed. It declared that "[l]ike the defendant in *Miller*, Boulware 'presented no concrete proof that the amounts were considered, intended, or recorded on the corporate records as a return of capital at the time they were made.'" App. 6 (quoting *Miller*, 545 F.2d at 1215).

The court of appeals' holding, like *Miller* itself, ignores the plain terms of 26 U.S.C. §§ 301 and 316. These statutes make clear that a corporate distribution to a shareholder not out of earnings and profits is nontaxable to the extent of the taxpayer's basis in the stock. *See, e.g., Bok*, 156 F.3d at 162. Sections 301 and 316 turn entirely on objective circumstances--whether the corporation had earnings or profits for the year in question and the taxpayer's basis in his stock. The statutes say nothing about the intent of the corporation or the taxpayer at the time of the distribution. The *Miller* court invented this requirement out of whole cloth.

As Judge Thomas recognizes in his concurrence, the *Miller* contemporaneous intent requirement produces an illogical anomaly: corporate distributions that do not count as income for civil tax purposes under the return of capital rule *do* count as income for purposes of the tax evasion and tax perjury statutes. App. 13-14. Thus, under the Ninth Circuit's approach, a shareholder who has no income under

26 U.S.C. § 301(c) and *Truesdell* and who therefore has no tax liability could nevertheless be found to have a "tax deficiency" under 26 U.S.C. § 7201 and to have falsely reported his (nonexistent) income under 26 U.S.C. § 7206(2). In other words, in the civil setting, a corporate distribution is a nontaxable return of capital, regardless of the intent of the taxpayer and the corporation at the time of the distribution, as long as the corporation has no earnings or profits and the distribution does not exceed the taxpayer's basis in his stock. But according to the Ninth Circuit, that same distribution constitutes taxable income for purposes of a criminal prosecution unless the taxpayer can show that, at the time of the distribution, he and the corporation intended a return of capital. Thus, the contemporaneous intent requirement "result[s] in a logical fallacy, [and] is in flat contradiction with the tax evasion statute's requirement of 'the existence of a tax deficiency.'" App. 13-14 (Thomas, J., concurring).

The court of appeals' decision conflicts squarely with the Second Circuit's decisions in *Bok* and *D'Agostino*. Those cases hold that

> in return of capital cases . . . the taxpayer or the corporation *need not have described the distribution at issue as a dividend or a return of capital at the time it was made*; rather, the realities of the transaction--including the amount of the shareholder's basis and the corporation's earnings or profits, as well as the amount of the distribution--govern its characterization for tax purposes.

Bok, 156 F.3d at 162 (citing *D'Agostino*, 145 F.3d at 72-73) (emphasis added).[4] As Judge Thomas concludes in his concurrence, "the Second Circuit's analysis is more consistent with the statutory requirements of criminal tax evasion." App. 13.

Although Judge Thomas rejects the *Miller* contemporaneous intent requirement, he concludes that applying the return of capital rule here would not affect the outcome of this case. App. 14. We respectfully disagree.

First, Judge Thomas contends that the return of capital rule does not apply if the diversion of funds from the corporation was unlawful. App. 14. It is far from clear that this is correct; the relevant statutes (26 U.S.C. §§ 301 and 316) say nothing about the lawfulness of the corporate distribution. But even if such an exception to the return of capital rule exists, it has no bearing here. Judge Thomas asserts that "[b]ecause Boulware claimed that the diversions were made to defraud his ex-wife from her share of property in the divorce proceedings, these diversions may be properly considered unlawful." App. 14 (citing *Boulware*, 384 F.3d at 801). But the language Judge Thomas cites from *Boulware* does not support a finding that Boulware obtained the money from HIE to defraud his ex-wife, or even that he "claimed" to have done so.[5] The district court made no finding that the distributions from HIE to Boulware were for that purpose, and the government never argued before the panel on appeal that the distributions were unlawful. And even if there were record support for Judge Thomas' contention, whether a

[4] *See also United States v. Peters*, 153 F.3d 445, 460-61 (7th Cir. 1998) (noting split in circuits over return of capital defense).

[5] Judge Thomas apparently cites to allegations in the Hawaii state court counterclaim that Boulware and HIE brought against Jin Sook Lee. But nothing in those allegations supports the proposition that Boulware diverted money from HIE to defraud his ex-wife.

corporate distribution can be considered unlawful so as to defeat the return of capital rule is a question of fact that the court of appeals should not decide in the first instance; the proper approach would be to remand for appropriate fact-finding in the district court.

Second, Judge Thomas asserts that the fact that Boulware was not the sole shareholder of HIE would "likely preclude him from asserting a return to capital defense." App. 14. In support of this contention, Judge Thomas notes that the courts in *Truesdell* and *Bok* applied the return of capital rule to distributions to sole shareholders. But 26 U.S.C. § 301(a) addresses distributions by a corporation to *a shareholder*, not distributions by a corporation to *the sole shareholder*. Nothing in *Truesdell* or *Bok* suggests that the return of capital rule is limited to sole shareholders. *See, e.g., Bok*, 156 F.3d at 162 ("We have long recognized that under certain circumstances monies lawfully withdrawn from a corporation by *one of its shareholders* may constitute a non-taxable return of capital." (citations omitted; emphasis added)). Contrary to Judge Thomas' view, therefore, overruling the *Miller* contemporaneous intent requirement in favor of the return of capital rule in *Bok* and *D'Agostino* would directly affect Boulware's case.

For these reasons, this case provides an appropriate vehicle for the Court to resolve the split between the Second and Ninth Circuits over the proper application of the return of capital rule in criminal tax cases. The Court should grant the writ and overrule the erroneous and illogical application of that rule in *Miller* and by the court of appeals below.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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May 2007

470 F.3d 931

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA, *Plaintiff-Appellee*, v. MICHAEL H. BOULWARE, *Defendant-Appellant*.	No. 05-10752 D.C. No. CR-99-00239-ER Opinion

Appeal from the United States District Court
for the District of Hawaii
Edward Rafeedie,* Senior District Judge, Presiding

Argued and Submitted
October 16, 2006 – San Francisco, California

Filed December 13, 2006

Before: Pamela Ann Rymer and Sidney R. Thomas,
Circuit Judges, and Stephen G. Larson,** District Judge

Opinion by Judge Rymer;
Concurrence by Judge Thomas

COUNSEL

John D. Cline, Jones Day, San Francisco, California, for the defendant-appellant.

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* The Honorable Edward Rafeedie, Senior District Judge for the Central District of California, sitting by designation.

** The Honorable Stephen G. Larson, United States District Judge for the Central District of California, sitting by designation.

Alan Hechtkopf (signed the brief) and Karen M. Quesnel, Department of Justice, Tax Division, Washington, D. C., for the plantiff-appellee.

OPINION

RYMER, Circuit Judge.

In a return trip following retrial after we reversed his first conviction, *United States v. Boulware*, 384 F.3d 794 (9th Cir. 2004) (*Boulware I*), Michael H. Boulware appeals his conviction and sentence for filing a false tax return in violation of 26 U.S.C. § 7206(1), tax evasion in violation of 26 U.S.C. § 7201, and conspiracy to make a false statement to influence a financial institution in violation of 18 U.S.C. § 1014. We conclude there is no reversible error, and affirm.

I

Without belaboring the background recited in our prior opinion, Boulware is the founder, former President, and majority owner of a closely held corporation, Hawaiian Isles Enterprises (HIE). HIE dealt in tobacco distribution, coffee processing and sales, arcade games, vending machines, and bottled water. A second superceding indictment charged Boulware with thirteen (later reduced to nine) counts of tax evasion and tax fraud in connection with his failure to report funds diverted from HIE as income for the years 1989-97; one count of conspiracy to make a false statement to influence a financial institution in connection with HIE's use of false invoices in applying for a loan from GECC Finance Corporation; and four counts of making a false statement to influence a financial institution in connection with the false invoices. Boulware

was convicted on the tax counts and the conspiracy count, which we reversed on the ground that the district court had erroneously excluded evidence of a Hawaii state court's adjudication of property rights in certain funds diverted from HIE. *Boulware I,* 384 F.3d at 800-09. On retrial as originally, the government's theory was that during the period 1989-1997, through a number of different devices, Boulware diverted more than $10 million from HIE and failed to report or pay taxes on this income; and that he used fraudulent invoices in applying for a bank loan. He was convicted on all counts. The district court again sentenced Boulware to 36 months' imprisonment on the false return counts, but increased the sentence from 51 to 60 months on the tax evasion and conspiracy counts, all to run concurrently.

Boulware timely appeals.

II

Boulware first claims that the district court erred in excluding evidence that he contends would have shown that the funds he took from HIE were nontaxable returns of capital rather than income. An essential element of the crime of tax evasion is the existence of a tax deficiency. *Boulware I,* 384 F.3d at 810. However, for purposes of civil tax liability, when a distribution from a corporation to its shareholder constitutes a return of capital, that distribution is normally not taxable. 26 U.S.C. §§ 301, 306; *United States v. Miller,* 545 F.2d 1204, 1210-12 & n.5 (9th Cir. 1976). Hence, to negate the tax deficiency element, Boulware sought to show that the money he received from HIE constituted returns of the capital he had invested as the corporation was, at the time, without earnings or profits.

The government moved in limine to preclude a "return of capital" defense, relying on *Miller*. There, we held that constructive distribution rules applicable in the civil arena could not be automatically applied to a criminal tax matter in the absence of some demonstration on the part of the defendant or corporation that distributions were intended to be a return of capital. *Id.* at 1214-15. In response, Boulware argued that whether corporate funds could be characterized as a return of capital is a question of fact for the jury, and he proffered testimony of an expert who would explain that if the monies transferred from HIE to Boulware were not loans or advances, or if Boulware did not use those funds for corporate purposes, then the transfer could be deemed a constructive dividend or return of capital to Boulware which may or may not be income to him depending upon whether HIE had earnings and profits for the years when the transfers occurred. The district court ruled that this offer of proof did not meet the *Miller* threshold because the defendant must show not merely that the funds *could* have been a return of capital, but that the funds were *in fact* a return of capital at the time of the transfer.

Boulware contends that the district court misread *Miller*. In his view, the issue in *Miller* was whether the evidence was sufficient to convict the taxpayer in spite of his return of capital defense, not whether the taxpayer had made a sufficient initial showing to introduce evidence pertaining to that defense; thus, the rest of *Miller* – upon which the district court relied – is dicta. We disagree that any part of *Miller's* reasoning can be disregarded. *See Barapind v. Enomoto,* 400 F.3d 744, 750-51 (9th Cir. 2005) (holding that what a majority opinion says regarding an issue presented for review is the law of the

circuit, regardless of whether or not it is "in some technical sense 'necessary' to the disposition in the case"). Boulware concedes that *Miller* controls if this is so. Accordingly, his alternative position that imposing an intent requirement creates a disconnect between civil and criminal liability necessarily fails. We held in *Miller* that the characterization of diverted corporate funds for civil tax purposes does not dictate their characterization for purposes of a criminal tax evasion charge; rather, the appropriate characterization for criminal purposes is whether the defendant has willfully attempted to evade the payment or assessment of a tax. 545 F.2d at 1214. As we explained, "[w]here the taxpayer has sought to conceal income by filing a false return, he has violated the tax evasion statutes. It does not matter that that amount could have somehow been made non-taxable if the taxpayer had proceeded on a different course." *Id.* Boulware's reliance on *Truesdell v. Commissioner,* 89 T.C. 1280 (1987), where the U.S. Tax Court held that funds diverted from a corporation in excess of earnings and profits were returns of capital, is misplaced because *Truesdell* was a civil proceeding and thus inapposite given *Miller's* explicit holding that civil classifications of diverted corporate funds do not control in criminal cases. *See also United States v. Williams,* 875 F.2d 846, 849-52 (11th Cir. 1989) (approving *Miller* despite *Truesdell* and distinguishing between civil and criminal contexts); *United States v. Schmidt,* 935 F.2d 1440, 1446 (4th Cir. 1991) (noting that "[t]he important distinction between civil and criminal tax cases concerning the key element to be focused upon is compellingly set out in [*Miller*].").

Boulware also posits that requiring a defendant in a criminal case to show that a distribution was intended to

be a return of capital unconstitutionally shifts the burden of proof to the defendant, but again, we held in *Miller* and *Boulware I* that once the government has shown that the taxpayer diverted funds from the corporation and failed to report them, the burden shifts to the taxpayer to show that the funds constituted a return of capital. *Boulware I,* 384 F.3d at 811 (citing *Miller,* 545 F.2d at 1215 & n.13). Like the defendant in *Miller,* Boulware "presented no concrete proof that the amounts were considered, intended, or recorded on the corporate records as a return of capital at the time they were made." *Id.* at 1215. Nor were any adjustments made to HIE's books showing a return of capital to Boulware, or to his co-shareholder. *See id.* at 1214 n.12. Accordingly, the district court properly required a foundation to be laid before allowing the asserted defense to go forward, and properly rejected Boulware's proffer as inadequate.

Finally, Boulware points out that accepting the district court's interpretation of *Miller* puts us in conflict with the Second Circuit, which has held that a taxpayer need not show that the distribution was characterized as a return of capital at the time of the transaction. *See United States v. D'Agostino,* 145 F.3d 69, 72-73 (2d Cir. 1998); *United States v. Bok,* 156 F.3d 157, 162 (2d Cir. 1998) (holding that a showing that a corporation had no earnings and profits is sufficient to support a return of capital defense, but acknowledging that this is a departure from the prevailing view among federal courts). Whether or not the facts in this case would implicate the Second Circuit's rule, which is by no means certain, we are satisfied that the district court correctly interpreted and applied *Miller* by which it, and we, are bound.

III

Secondly, Boulware challenges exclusion of evidence that he believes would have shown that HIE overpaid tobacco taxes and was simply making up for the overpayment by under-reporting income. The district court sustained a relevance objection to testimony by Boulware's attorney regarding advice he had given Boulware about payment of these taxes, and to testimony by HIE's controller regarding tax adjustments made on HIE's books. Boulware himself, however, was allowed to testify that HIE had been overpaying its tobacco taxes and had tried to recoup these overpayments by underpaying in subsequent periods and adjusting its books accordingly. He admitted that this was "self-help," and testified that he did not understand the increase in HIE's income to have any effect on his own taxes.

We discern no error. Boulware failed before the district court to link the excluded testimony about HIE's tobacco taxes to his personal income taxes, and fares no better before us. His suggestion that tobacco tax evidence was probative of intent lacks factual or legal support. In any event, nothing about it indicates that Boulware did not have income that he failed to report on his personal return. Although the court allowed some exploration of the subject at Boulware's behest, it retained discretion to curtail the extent of it. As the subject itself lacked relevance, the court likewise properly refused to read HRS 245-7 to the jury; whether or not HIE's method of tax recovery was legal under state law had no bearing on whether Boulware was guilty of federal tax evasion or tax fraud.

IV

Boulware next asserts that the court's receipt of a summary exhibit categorizing and organizing a series of schedules listing each financial transaction pertaining to his taxable income over the relevant period offended Rule 1006 of the Federal Rules of Evidence. The government introduced the compilation (Exhibit 3300) through its summary witness, IRS Agent Randall Tanahara. Boulware objected on the ground that Exhibit 3300 was cumulative and not allowed of a summary witness. The court overruled the objection. Later, Boulware moved to strike the exhibit on the ground that it merely summarized evidence already in the record, which the court denied. Boulware did not (and does not) dispute the accuracy of the information contained in the schedules. The jury was instructed that charts and summaries are only as good as the underlying supporting material admitted into evidence, and that the jury should give them only such weight as it thinks the underlying material deserves.

Boulware relies on *United States v. Wood,* 943 F.2d 1048 (9th Cir. 1991), *United States v. Soulard,* 730 F.2d 1292 (9th Cir. 1984), and *United States v. Abbas,* 504 F.2d 123 (9th Cir. 1974), as articulating a bright-line rule against admission of summary charts as evidence. There is no question that, as *Wood, Soulard,* and *Abbas* indicate, we do not approve of receiving summary exhibits of material already in evidence; however, in none of these cases did we reverse for this reason. Moreover, we have elsewhere recognized a district court's discretion under Fed.R.Evid. 611(a) to admit summary exhibits for the purpose of assisting the jury in evaluating voluminous evidence. *See, e.g., United States v. Poschwatta,* 829 F.2d 1477, 1481 (9th Cir. 1987) (holding that admission of a

chart summarizing income figures already admitted into evidence, while perhaps not the best practice, was not an abuse of discretion); *United States v. Gardner,* 611 F.2d 770, 776 (9th Cir. 1980) (holding that admission of a chart summarizing the defendant's financial status was well within the discretion of the trial court pursuant to Fed.R.Evid. 611(a)). Here, the court no doubt believed that it would be helpful to have the voluminous financial materials reduced to summary form (even though, as it happens, the summary was 116 pages long). Nevertheless, we do not need either to embrace or condemn the procedure followed in this case because, even if it were error to allow the summary exhibit into evidence, the error is harmless given admissibility of the underlying data, lack of objection to accuracy of the summary, and the limiting instruction. *See United States v. Krasn,* 614 F.2d 1229, 1238 (9th Cir. 1980) (holding that charts should not have been admitted, but that it was harmless error as the defendant had an opportunity to challenge the facts and data upon which the charts were based and the court gave a limiting instruction); *Gardner,* 611 F.2d at 776 (noting the defendant's opportunity to cross-examine the government witness who prepared the chart and finding no reversible error in admission of chart); *Abbas,* 504 F.2d at 125 (same).

V

The government questioned Boulware during cross-examination about a letter that he had written to his girlfriend, Jin Sook Lee, soon after divorcing his wife in 1994. The letter referred to gifts Boulware had bought for Lee, including a diamond that he testified was purchased with a credit card. The letter was not received into

evidence. A 1991 invoice with the name "Gina Lee" reflecting sale of a 5.03 carat diamond for $70,000 was in evidence; this purchase was evidently by cashier's check. The Assistant United States Attorney (AUSA) argued in closing that, based on his recollection, Boulware had "lied to you during the course of this case" about how he bought the diamond and that if he would lie about how he bought a diamond for $70,000, he would lie about how he got $10 million. The day after closing arguments were concluded, Boulware moved for a mistrial, or alternatively, for an instruction about the government's misstatement. The court denied both requests. It found that the AUSA simply made a mistake in good faith and that, assuming the argument was improper, it was not prejudicial because it was but a single part of an extensive litany of evidence showing Boulware's lack of veracity, it had to do with a fifteen-year old event, and the AUSA stated that he was only relating his own recollection.

Even if the AUSA's recollection – thus his statement to the jury – were incorrect, the district court did not clearly err in its findings or abuse its discretion in denying Boulware's requests. The inaccuracy of the AUSA's characterization was not immediately apparent, and the record was somewhat ambiguous given references to different diamond purchases. Regardless, it is unlikely that the statements materially affected the trial. The jury was instructed that statements of counsel are not evidence, and that the jury's recollection of the evidence controls. *See United States v. Kerr,* 981 F.2d 1050, 1053 (9th Cir. 1992) (observing that "[t]o determine whether the prosecutor's misconduct affected the jury's verdict, we look first to the substance of a curative instruction."). The point was but one of many made in closing about Boulware's

credability. And the evidence against Boulware was strong. *See United States v. Weatherspoon,* 410 F.3d 1142, 1151 (9th Cir. 2005) (noting importance of the strength of the case against a defendant in measuring prejudicial effect of improper statements).

VI

We reversed Boulware's first conviction because the district court had erroneously excluded evidence of a state court judgment establishing that money Boulware had taken from HIE and given to Lee was not a gift to her, but rather belonged to HIE and was being held in trust by Lee. *Boulware I,* 384 F.3d at 798, 800. Although we held that the judgment was relevant, we also rejected Boulware's argument that it was controlling on the issue of whether the money held by Lee belonged to HIE and was therefore not taxable to him. The district court on retrial received the state court judgment into evidence, but it instructed the jury that the state court judgment determined that the money that Boulware transferred to Lee remained the property of HIE; that this determination was not binding on the jury; but that the judgment could be considered in determining the purpose of the transfer and whether it constituted unreported income to Boulware.

Boulware now maintains that the state court judgment resolving the property dispute between Lee and HIE is binding on the federal courts and, additionally, that *Boulware I* was wrong in concluding otherwise. However, *Boulware I* is the law of the case, and controlling. *Jeffries v. Wood,* 114 F.3d 1484, 1489 (9th Cir. 1998) (en banc). Under our mandate, "the district court did not err in ruling that the state court judgment does not have preclusive effect as

to the ownership of the monies." *Boulware I,* 384 F.3d at 805. The court's instructions on remand were faithful to *Boulware I,* and thus were not erroneous.

VII

Boulware's press for reversal based on cumulative error fails as there is no accumulation.

VIII

Boulware raises two issues with respect to his sentence. First, he contends that the court's imposing a 60-month term of custody on the tax evasion and conspiracy counts is vindictive given that his original sentence on these counts, before reversal, was to 51 months. We disagree. Different evidence was adduced upon retrial. For example, Nathan Suzuki testified about Boulware's continuing fraudulent activities even after he knew about the government's investigation. Additional evidence could lead the district judge to find that an increased sentence was objectively justified. *Wasman v. United States,* 468 U.S. 559, 565 (1984).

Additionally, Boulware argues that his sentence of 60 months on the conspiracy conviction is unreasonable and must be vacated if the tax counts are reversed. As we affirm conviction on the tax counts, the premise of Boulware's challenge to the conspiracy sentence disappears.

AFFIRMED.

THOMAS, Circuit Judge, concurring:

I agree entirely with the analysis and conclusions of the majority. I write separately only to comment that if we were writing on a clean slate, rather than under the controlling precedent of *United States v. Miller,* 545 F.2d 1204, 1211-15 (9th Cir. 1976), I would adopt the approach of the Second Circuit concerning the return to capital defense. *See United States v. Bok,* 156 F.3d 157, 162 (2d Cir. 1998); *United States v. D'Agostino,* 145 F.3d 69, 72-73 (2d Cir. 1998).

I believe the Second Circuit's analysis is more consistent with the statutory requirements of criminal tax evasion. The elements of criminal tax evasion under 26 U.S.C. § 7201 are: "(1) the existence of a tax deficiency, (2) willfulness in attempted evasion of taxes, and (3) an affirmative act constituting an evasion or attempted evasion." *United States v. Marabelles,* 724 F.2d 1374, 1380 (9th Cir. 1984). Thus, an explicit requirement to impose liability under § 7201 is "the existence of a tax deficiency." As the majority opinion notes, notwithstanding a taxpayer's wrongful intent regarding diverted income, a sole shareholder of a company cannot be held civilly liable for any distribution that exceeds the earnings and profits of the corporation and that does not exceed the shareholders adjusted basis in the stock – instead such diversions are considered a return of the shareholder's capital investment. *Truesdell v. Commissioner,* 89 T.C. 1280, 1294-95, (T.C. 1987) (relying on 26 U.S.C. §§ 301, 306). *See also United States v. Miller,* 545 F.2d 1204, 1210-12 & n.5 (9th Cir. 1976). Thus, *Miller* – and now the majority opinion – hold that a defendant may be criminally sanctioned for tax evasion without owing a penny in taxes to the government. Not only does this result indicate a logical fallacy, but is in

flat contradiction with the tax evasion statute's requirement of "the existence of a tax deficiency." *Marabelles,* 724 F.2d at 1380. Therefore, without the constriction of *Miller,* I would hold that the Second Circuit approach to the return to capital defense is the better one, adopting the approach that "the return of capital theory applies equally in both criminal and civil cases, assuming the diversion itself was not unlawful." *Bok,* 156 F.3d at 162 (citing *D'Agostino,* 145 F.3d at 72-73).

I emphasize that even if we were to apply *Bok* and *D'Agostino* to the case at hand, the outcome would not be affected. *Bok* expressly holds that the return to capital defense does not apply if the diversion itself were unlawful. *Bok,* 156 F.3d at 162. More broadly, the Internal Revenue Service does not consider distributions to be a return to capital if made for unlawful purposes. *Truesdell,* 89 T.C. at 1298 (only permitting the return to capital defense after determining that the diversions "were not per se unlawful [,] . . . not, at least on their face, stolen, embezzled or diverted in fraud of creditors"). Because Boulware claimed that the diversions were made to defraud his ex-wife from her share of property in the divorce proceedings, these diversions may be properly considered unlawful. *United States v. Boulware,* 384 F.3d 794, 801 (9th Cir. 2004). In addition, the record indicates that Boulware was not a sole shareholder of HIE, which would also likely preclude him from asserting a return to capital defense. *See Truesdell,* 89 T.C. at 1282 (petitioner was president and sole shareholder of the company from which funds were diverted); *Bok,* 156 F.3d at 160 (similarly applying the return to capital defense in the context of a sole shareholder).

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA,	)	CRIMINAL NO. 99-00239ER
Plaintiff,	)	– VOLUME 5 –
vs.	)	
MICHAEL H. BOULWARE,	)	
Defendant.	)	

TRANSCRIPT OF PROCEEDINGS

The above entitled matter came on for hearing on Friday, July 1, 2005, at 9:11 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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* * *

[160] and not to form or express any opinions or conclusions about this case until it has been submitted to you.

You are excused.

THE CLERK: All rise for the jurors.

(The jury was excused at 1:14 p.m.)

(The following proceedings were held in open court, outside the presence of the jury:)

THE COURT: I can think of no conceivable theory of admissibility for this group of documents labeled Exhibit 2010, because it is a conglomerate of things, including deposition testimony, including copies of checks, including statements of banks, etc.

So the court will – that will not be the last word.

If you file with me a justification to admit this under some pertinent evidentiary rule, I will consider it.

But, as of now, I'm not –

And you're the one that objected to it. You should file whatever objection that you have, other than your – other than that you don't like it.

MR. DWYER: Yes, Your Honor.

THE COURT: That is not a good objection. Which both sides have used.

Now, the other issue:

One other issue, that the government has filed a motion in limine to preclude the introduction of evidence

[161] relating to the issues of constructive distribution and return of capital.

This motion would prevent the defendant from arguing that monies diverted from Hawaiian Island to Boulware were actually a return of the defendant's capital investment in the company.

I want to quote to you now from a case, which I will cite in a moment:

"Evidence of unexplained funds in the taxpayer – of the tax – in the hands of the taxpayer establishes a prima facie case of understatement of income, making it incumbent on the taxpayer to overcome the logical inferences drawn from the facts proved," end quote, United States versus Garcia, 412 F.2d, 999, cited with approval by the Ninth Circuit in United States versus Miller, 545 F.2d, 1204.

Once the government had made out a prima facie case, in order for constructive distribution rules to apply, I quote again. This is from Miller.

Quote, "There must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return," end quote. Miller.

Now, as Miller held, it is not relevant whether the funds could have been classified as return of capital or a dividend at the time they were diverted.

There is a violation given where the diverted funds [162] could have qualified as a return of capital, when the taxpayer fails to report the money as income or record it as a return of capital on the corporate books.

Here, the government has made out the prima facie case required by Miller.

Thus, if the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions were intended to be a return of capital.

As the government points out, Mr. Manago, who was a witness, who was an employee of the defendant, has testified that there were no returns of capital during the years in question.

Unless the defendant introduces competent evidence that demonstrates otherwise, the constructive distribution rules would apply to this case – would not apply.

Because of the confusing and potentially prejudicial nature of this evidence, the court believes the matter should be resolved either in a hearing under Federal Rule of Evidence 104, which is to determine the existence of the preliminary facts necessary for admissibility, or if the defendant can make a showing by a written offer of proof, which the court will then consider in determining this issue.

So, what we will do is this:

We will probably hold a hearing.

I'll give you the choice. If you want to present [163] the evidence to the court outside the presence of the jury to demonstrate what I have just said, then I will consider that, and rule accordingly on the issue.

The court cannot rule at this point in time; in other words – for the reasons I have stated.

All right. Now, I think that that is all. We will reconvene on Tuesday, at 9:00 a.m. Try not to blow yourselves up, either.

(Laughter in the court.)

THE CLERK: All rise.

(The hearing in the above-entitled cause was concluded at 1:17 p.m.)

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA,	)	CRIMINAL NO. 99-00239ER
Plaintiff,	)	– VOLUME 8 –
vs.	)	
MICHAEL H. BOULWARE,	)	
Defendant.	)	

TRANSCRIPT OF PROCEEDINGS

The above entitled matter came on for hearing on Monday, July 11, 2005, at 9:07 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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Attorneys for the Defendant

* * *

[114] Accordingly, the court, without further foundation, will deny the HIE's motion for leave to present evidence of over-reporting of income.

That's subject to reconsideration if a foundation is laid.

The court will now address to the defendant's offer of proof relating to the issue of constructive dividends and returns of capital. Which suffers from the same lack of foundation.

As the court previously explained, the Miller decision, that states that it is not relevant whether the funds could have been classified as a return of capital or a dividend at the time when they were diverted.

There is a violation, even where the diverted funds could have qualified as a return of capital, when the taxpayer fails to properly report the money as income or record it as a return of capital on the corporate books.

That's found at Page 1214 of that decision, 545 F.2d, 1204.

The defendant's offer of proof merely indicates that the defendant would introduce expert testimony that the funds at issue could have been considered return of capital.

Not only would much of this evidence be excludable as expert legal opinion, it is plainly insufficient under the Miller case.

[115] The defendant must not show merely that the funds could have been a return of capital; he must introduce

evidence showing that, at the time of the transfer, the funds were in fact a return of capital.

Based upon the defendant's offer of proof, the court cannot see any benefit in holding any additional hearing on this matter.

The offer of proof fails to satisfy the standard established in the Miller case. In fact, it is expressly contrary to that standard.

And the government's motion in limine to exclude evidence relating to constructive dividends or returns of capital is hereby granted.

Now, this may very well apply to this Hawaii tax adjustment, as well.

But did you wish to be heard on any other issue?

MR. O'CONNOR: Just to clarify, Your Honor.

THE COURT: Yeah?

MR. O'CONNOR: As I understand it, the court is ruling on the over-payment of taxes by the company. Is that correct?

THE COURT: That's right.

MR. O'CONNOR: The court –

THE COURT: Because you filed a motion offering evidence of over-payment –

[116] MR. O'CONNOR: Over-payment.

THE COURT: – of income, and an offer of proof relating to the issue of constructive dividends.

MR. O'CONNOR: A little while ago –

THE COURT: I am ruling on your motion and denying it.

MR. O'CONNOR: Yes, Your Honor.

The question is –

THE COURT: I shouldn't have to explain it.

MR. O'CONNOR: The question is: Can we put on evidence of payment of taxes –

THE COURT: No.

MR. O'CONNOR: – by HIE?

Not over-payment. But the fact that they paid taxes on –

THE COURT: How is that any different than the over-reporting of taxes?

But why is it relevant? It's two different taxpayers. Your client is an individual taxpayer; the corporation is a separate taxpayer.

MR. O'CONNOR: Well, it's relevant –

THE COURT: One ordinarily does not affect the other, unless there's a foundation laid to show that it should.

MR. O'CONNOR: We already have testimony in this

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA,	)	CRIMINAL NO. 99-00239ER
Plaintiff,	)	– VOLUME 11 –
vs.	)	
MICHAEL H. BOULWARE,	)	
Defendant.	)	

TRANSCRIPT OF PROCEEDINGS

The above entitled matter came on for hearing on Thursday, July 14, 2005, at 9:05 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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* * *

[26] for funds in transit at the beginning and end of the year.

The figure is then adjusted to remove deposits of funds which were not income, and to include income which was never deposited.

This adjusted figure is said to constitute a reconstructed gross income.

Calculation of taxable income then proceeds in the usual way, taking into account the legitimate deduction, exceptions, exclusions and credits.

If the resulting figure differs from what the taxpayer has reported, the government may argue that the difference is unreported taxable income.

Generally, the government must also establish the amount of cash the taxpayer had on hand at the beginning of the year, and exclude this amount. Because some deposits may be the product of the cash the taxpayer already possessed.

However, that is not necessary in this case, because the government did not include any deposits of cash in its analysis.

The state court judgment received into evidence determined that the money that the defendant transferred to his girlfriend, Jin Sook Lee, was not a gift, and remained the property of Hawaiian Isles Enterprises.

That determination is not binding on you.

It may, however, be considered, along with all other [27] evidence, in determining the purpose of the transfer of

the money, and whether it constituted unreported income to the defendant.

The evidence from which you are to decide the facts of the case are – consist of the following:

The sworn testimony of any witness, the exhibits which have been received into evidence, and any facts to which all the lawyers have stipulated.

In reaching your verdict, certain things are not evidence, and you may not consider them in deciding what the facts are.

I will list these for you:

Arguments and statements of the lawyers are not evidence. The lawyers are not witnesses. What they have said in their opening statements, closing arguments, and at other times, is intended to help you interpret the evidence, but it is not evidence.

If the facts as you remember them differ from the way the lawyers state them, your memory of them controls.

Now, secondly, questions and objections by lawyers are not evidence.

Attorneys have a duty to their client to object when they believe a question is improper under the rules of evidence.

You should not be influenced by the question, the

* * *

384 F.3d 794

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA, *Plaintiff-Appellee*, v. MICHAEL H. BOULWARE, *Defendant-Appellant.*	No. 02-10287 D.C. No. CR 99-0239 ER
UNITED STATES OF AMERICA, *Plaintiff-Appellant*, v. MICHAEL H. BOULWARE, *Defendant-Appellee.*	No. 02-10338 D.C. No. CR 99-0239 ER OPINION

Appeal from the United States District Court
for the District of Hawaii
Edward Rafeedie, District Judge, Presiding

Argued and Submitted
December 1, 2003 – San Francisco, California

Filed September 14, 2004

Before: A Wallace Tashima, Sidney R. Thomas, and
Barry G. Silverman, Circuit Judges.

Opinion by Judge Tashima;
Dissent by Judge Silverman

COUNSEL

Dennis E.W. O'Connor, Honolulu, Hawaii, for the defendant-appellant and cross-appellee.

Karen M. Quesnel, Tax Division, U.S. Department of Justice, Washington, D.C., for the plaintiff-appellee and cross-appellant.

OPINION

TASHIMA, Circuit Judge:

Michael H. Boulware appeals from his conviction, after trial by jury, on five counts of filing false tax returns, four counts of tax evasion, and one count of conspiracy to make false statements to a federally-insured financial institution. He contends that all of his convictions must be reversed because the government failed to meet its burden of proof on the tax counts, constructively amended the indictment during trial, and engaged in prosecutorial misconduct. He also contends that the district court prejudicially erred in excluding key evidence and giving inadequate and misleading jury instructions. Finally, he contends that his sentence must be vacated, because the district court failed to resolve factual disputes regarding the amount of the tax loss. In its cross-appeal, the government contends that the district court erred by refusing to enhance Boulware's sentence for obstruction of justice.

Although most of the errors alleged by Boulware do not warrant reversal of his convictions, one of them does. The district court abused its discretion by excluding evidence of a state-court judgment that directly supported Boulware's defense to the tax charges and that directly contradicted the government's theory of the case – that

Boulware had stolen money from his closely-held corporation and gifted it to his girlfriend. As the error went to the heart of Boulware's defense and was not harmless beyond a reasonable doubt, Boulware is entitled to a new trial on the nine tax counts.

I

After a six-year investigation by the Internal Revenue Service ("IRS"), Boulware was indicted on four counts of filing false tax returns for the 1989-1992 tax years, in violation of 26 U.S.C. § 7206(1), one count of conspiring to make a false statement to a federally-insured financial institution, in violation of 18 U.S.C. § 371, and four counts of making such false statements, in violation of 18 U.S.C. § 1014. A tenth count sought forfeiture of funds associated with the false statements. A superseding indictment added five new counts of filing false tax returns, for the 1993-1997 tax years. and four counts of tax evasion, in violation of 26 U.S.C. § 7201, for the 1994-1997 tax years. Finally, a second superseding indictment ("the indictment"), amended the factual allegations of the conspiracy count.

After a six-day trial and two-and-a-half days of deliberations, the jury convicted Boulware on November 29, 2001, of all nine tax counts.[1] The jury also convicted him of conspiring to make false statements to a federally-insured financial institution, but acquitted him of the substantive false statements counts. The district court sentenced Boulware to a 36-month term of imprisonment on each of

[1] During trial, the false tax return counts for the 1994-1997 tax years were severed, redacted from the indictment, and later dismissed with prejudice.

the false tax return counts, 51 months on each of the tax evasion counts, and 51 months on the conspiracy count, all terms to run concurrently.[2]

II

Boulware started M&S Vending in 1979, while working as a telephone repairman. The company placed video games in bars and restaurants, and it quickly expanded into other lines of business, such as cigarette sales. In about 1985, the company was renamed Hawaiian Isles Enterprises ("HIE"); Boulware owned all of the shares. HIE branched out into coffee roasting and sales, and formed a subsidiary named Hawaiian Isles Kona Coffee Company. Boulware later acquired a bottled water company and transferred its stock to HIE. By 1989, HIE was reporting gross receipts of over $55 million, and by 1992 sales had topped $85 million.

At trial, the government sought to prove that Boulware had systematically diverted funds from HIE in order to support a lavish lifestyle. In particular, that he gave millions of dollars of HIE money to his girlfriend, Jin Sook Lee, and millions of dollars to his wife, Mal Sun Boulware, without reporting any of this money on his personal income tax returns. According to the government, he siphoned off this money primarily by writing checks to employees and friends and having them return the cash to him, by diverting payments by HIE customers, by submitting fraudulent invoices to HIE, and by laundering HIE

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[2] The court also imposed a three-year term of supervised release, fines, and forfeiture of $495,814.

money through companies in the Kingdom of Tonga and Hong Kong.

With regard to the false statements counts, the government attempted to prove that Boulware and a business associate named Lorin Kushiyama received financing from General Electric Credit Company ("GECC") based on the submission of false invoices. In particular, the government tried to prove that the financing was purportedly to allow Kushiyama's company to purchase video game machines that it would then lease or sell to HIE. According to the government, HIE already owned the machines and Kushiyama gave the loan proceeds to Boulware.

The defense case was that Boulware did not underreport income in any of the relevant tax years, because HIE maintained beneficial ownership of all of the funds in question. Even if he did underreport his income, he at all times acted in good-faith reliance on the advice of counsel.

According to Boulware, he intended to use most of the money at issue in this case to buy out his wife's marital interest in HIE and the money was therefore not, or at least arguably not, taxable to him. He asked his wife for a divorce in 1987, and she threatened to force him to liquidate HIE unless he agreed to give her $5 million and a $1 million house. Boulware and his wife realized that it would take time for HIE to buy out her interest. When he told Jin Sook Lee about the agreement, she asked to hold the money as it was accumulating, because she wanted to make sure he saved it for the divorce. His lawyer advised him that (1) his wife had a right to half of the company as her marital share of HIE, and (2) if Lee held the funds in

trust for HIE, the money would not be taxable to Boulware.

Boulware testified that by 1994 he had collected enough HIE money to redeem his wife's share of the company and finalize their divorce. Lee, however, refused to return the money. For this reason, Boulware had to scramble to obtain other funds to buy out his wife's marital interest. For example, he received a $1.7 million loan from Harold Okimoto. Finally in 1997, a Hawaii state-court jury found that the money Lee was holding belonged to HIE. The state court ordered Lee to return the money to HIE.

The defense also tried to show that, despite Boulware's success as an entrepreneur, he was a relatively unsophisticated person who neither understood nor paid attention to accounting issues. A certain disregard of corporate formalities was also due to the fact that he owned and ran the company. In addition, the nature of his business (*e.g.*, purchasing coffee beans in cash from growers on Kona) required that he receive corporate advances to make deals. He always informed his comptroller Merwyn Manago of these transactions, and they were (or Boulware was under the impression that they were) reported on HIE's books and tax returns.

With regard to the GECC loans, the defense made a case that the transactions were not fraudulent. What the government portrayed as false invoices were really legitimate appraisals of the video game machines, which were to serve as collateral for a loan from GECC to HIE.

III

A. Exclusion of the State-Court Judgment

Boulware argues that the district court improperly excluded evidence of a Hawaii civil judgment, which determined that HIE owned the money that Boulware had given to Jin Sook Lee between 1987 and 1994. As the state court found that Boulware had not gifted the funds to Lee and that the funds belonged to HIE, he contends that he had no federal tax liability for those funds. He argues that the improper exclusion of this evidence violated his due process right to present evidence in his defense.

1. Standard of Review

We generally review a district court's evidentiary rulings for abuse of discretion. *United States v. Sua*, 307 F.3d 1150, 1152 (9th Cir. 2002), *cert. denied*, 537 U.S. 1221 (2003). Under this standard, reversal is appropriate only where the trial court made an error of law or a clearly erroneous finding of fact, or where the reviewing court has "'a definite and firm conviction that the district court committed a clear error of judgment.'" *United States v. Finley*, 301 F.3d 1000, 1007 (9th Cir. 2002) (quoting *United States v. Benavidez-Benavidez*, 217 F.3d 720, 723 (9th Cir. 2000)). We review de novo the district court's interpretations of the Federal Rules of Evidence. *United States v. Angwin*, 271 F.3d 786, 798 (9th Cir. 2001).

2. Factual Background

On October 7, 1994, over a year after Boulware became aware that the IRS was investigating him, but four-and-a-half years before he was indicted, Jin Sook Lee

filed a complaint for conversion, breach of contract, and unjust enrichment against Boulware and HIE in Hawaii state court. In the complaint, Lee alleged that Boulware, individually and as an agent of HIE, had taken $840,000 in cash from a safe in her home, had wrongfully acquired a real property belonging to her, and had defaulted on a $1.2 million note. She sought compensatory and punitive damages.

On November 17, 1994, Boulware and HIE answered Lee's complaint and denied all the relevant allegations. Boulware and HIE also filed a counterclaim against Lee for breach of contract, breach of fiduciary duty, unjust enrichment, constructive trust, conversion, quiet title, accounting, declaratory relief, cancellation of instruments, and compensatory and punitive damages.

In Boulware and HIE's counterclaim, they alleged the following facts regarding the payments to Lee:

> 5. In 1987, Boulware was married to Mal Sun Boulware. At that time, due to irreconcilable differences, Michael Boulware and Mal Sun Boulware agreed that they would get divorced because their marriage was beyond redemption. Boulware understood and realized that division of the marital property would require substantial sums of cash and properties in order to satisfy his wife's demands. Boulware wanted to insure that he would not have to sell [HIE] as a result of the divorce. Boulware advised Lee that he and his wife had decided to divorce and advised her of the parties' property division discussions and agreements and that such agreements would require the payment of substantial sums in cash and properties. . . .

> 6. Commencing in or about 1987 [HIE] advanced monies from time to time to Boulware pursuant to oral and written understandings and debt instruments whereby Boulware agreed to account for and repay all such monies not properly accounted for as business expenditures incurred on behalf of the company. Commencing in or about 1987 and continuing through approximately 1993, Boulware transferred directly to Lee, or caused [HIE] to deliver to Lee, certain monies pursuant to the oral and written understandings referenced above. At all times, Lee understood and agreed that all such funds not used by Boulware and Lee for purposes of advancing the business interests of [HIE], had to be repaid in full to Boulware and [HIE]. Lee further understood and agreed that a portion of the funds paid back by her would be used to satisfy the property settlement agreements between Boulware and his then wife Mal Sun Boulware.
>
> * * *
>
> 22. At all times relevant herein, a confidential relationship existed between Lee and Counterclaimaints. Based upon and arising out of said confidential relationship, Counterclaimants transferred to Lee monies and properties valued in excess of $5 million. Lee promised to hold said assets for the benefit of [HIE] and to prevent their dissipation and to reconvey them to Counterclaimants upon demand. . . .

Boulware and HIE sought a declaration that the transfers to Lee were not gifts.

After a trial on the merits, the jury found that the monies were not gifts and that the monies belonged to

HIE. The relevant question on the special verdict form read, as follows:

> *Question No. 10.* Jin Sook Lee claims the cash and checks delivered to her, during the period from March, 1987 to May, 1994, by Michael Boulware and Hawaiian Isles Enterprises were gifts. Michael Boulware and Hawaiian Isles Enterprises claim the monies were not gifts but were to be held by Jin Sook Lee and to be returned when requested. State your findings below:
>
> The monies were gifts to Jin Sook Lee Yes _____ No ✓
>
> The monies belong to Hawaiian Isle Enterprises Yes ✓ No _____

Likewise, in deciding the equitable issues of unjust enrichment and constructive trust, the state court judge found by clear and convincing evidence that the monies were not gifts to Lee. The judgment provides in relevant part:

> As to Counts I, III, IV and V, judgment in favor of Defendant/Counterclaimant HAWAIIAN ISLES ENTERPRISES, INC. and against Plaintiff [Lee] in the amount of $4,551,931.00, said amount being the property of Defendant/Counterclaimant HAWAIIAN ISLES ENTERPRISES, INC. which has been and is being held in constructive trust by Plaintiff and by which Plaintiff has been and is being unjustly enriched[.]

In this case, Boulware moved to adopt as controlling the state court's determination that the money belonged at all times to HIE and was therefore not taxable to him. The

district court denied the motion on the ground that the jury only determined ownership of the money as between Lee and HIE, and was not asked to determine ownership as between HIE and Boulware.

Boulware then filed a motion in limine to preclude the government from referring to the monies transferred to Lee as gifts, a factual issue that had been subject to adversarial testing in the state court, or alternatively to allow the introduction of the state court judgment to rebut the government's gift theory. The government in turn filed a motion in limine to exclude introduction of the state court judgment on four grounds: (1) the judgment had no preclusive effect, because the United States was not a party to the state action; (2) the state court judgment was not relevant, because it determined ownership of the moneys only as between Lee and HIE and so was not inconsistent with the theory that the money was reportable income to Boulware; (3) the judgment was unreliable, and admitting the judgment would confuse the jury and would lead to a mini-trial to show the deficiencies in the evidence considered in the state case; and (4) the judgment was inadmissible hearsay.

In Boulware's opposition to the government's motion in limine, he argued that collateral estoppel is not the issue. Rather, as a determination of property rights, the state court judgment has preclusive effect for purposes of determining whether he had a federal tax liability. In addition, the state court judgment was relevant to the issue of whether he gifted money to Lee and thereby diverted HIE money for personal purposes. The judgement would also allow him to argue that his failure to amend his tax returns was in good-faith reliance on the state court judgment. He further argued that the district court

did not have jurisdiction to question the reliability of the state court judgment absent a showing of collusion. Finally, Boulware argued that the judgment was admissible as a record of property rights under Federal Rule of Evidence 803(14), and that its probative value far outweighed any danger of unfair prejudice, confusion of the issues, or waste of time.

The district court granted both motions, explaining that "the characterization of this transfer as a gift is not relevant to the ultimate issues of the case" and that the jury should decide the case based on the testimony of the witnesses. The court ruled that no witnesses should discuss the state court judgment, but that he would leave the matter open to reconsideration.

At trial, the government at times suggested to the jury that Boulware gave the money to Lee as a gift, arguing, for example, that Boulware spent the money "to support a lifestyle of a Porsche, a Blazer, a Mercedes; enough of a lifestyle to support an estate in Kahala; support both a wife and a girlfriend, both of whom received millions of dollars. . . ." At other times, however, the government argued that Boulware gave the money to Lee to hide it from the IRS, to hide it from his wife, or to use HIE money to pay off his own obligation to his ex-wife, arguing, for example, that Boulware took the money so that he "could dump his wife without paying a dime." The court sustained the government's objections to questions about the judgment. Boulware himself testified without objection, however, that he ended up in a lawsuit with Lee to force her to return the money, and that she was forced to return $5 million or $6 million to HIE.

3. Analysis

a. *Does the State Judgment Have Preclusive Effect?*

Boulware argues that the state court judgment precluded the government from relitigating the ownership of the funds he delivered to Lee. He bases his argument not on the affirmative defense of collateral estoppel, because the government was not a party to the state lawsuit, but rather on the principle that state law determines the property rights to which federal law attaches tax consequences. Because the state court jury found that Boulware had not gifted the funds to Lee and that the funds belonged t HIE, he argues that he had no federal tax liability for those funds. We disagree.

Boulware relies on cases such as *Freuler v. Helvering,* 291 U.S. 35 (1934), *Blair v. Comm'r,* 300 U.S. 5 (1937), and *Flitcroft v. Comm'r,* 328 F.2d 449 (9th Cir. 1964). These tax cases stand for the proposition that federal courts must treat as binding state court determinations on questions of state law as long as the judgments were not obtained through collusion. In *Flitcroft,* for example, the question was whether the retroactive reformation of a trust by a state court could wipe out a federal tax liability for previous years. *Id.* at 453. We held that the state court proceeding was not collusive and therefore "the adjudication of the state court is given effect, 'not because it is res judicata against the United States, but because it is conclusive of the parties' property rights which alone are to be taxed.'" *Id.* at 459 (quoting *Gallagher v. Smith,* 223 F.2d 218 (3d Cir. 1955)).

These authorities, however, have somewhat been called into question by the Supreme Court's 1967 decision in *Commissioner v. Bosch,* 387 U.S. 456 (1967). There, the

Court held that "where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such property interest by a state trial court." *Id.* at 457; *see also id.* at 465 ("[W]hen the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should *a fortiori* not be controlling"). *Bosch* is distinguishable, however, because it dealt with the federal estate tax statute, and the Court appeared to give great weight to a statement in the legislative history that " 'proper regard,' not finality, 'should be given to interpretations of the will' by state courts and then only when entered by a court 'in a bona fide adversary proceeding.' " *Id.* at 463-64.

It is clear, therefore, that with regard to the calculation of estate taxes, federal courts are not bound by the judgments of a state probate court. *See, e.g., Estate of Rapp v. Comm'r,* 140 F.3d 1211, 1215-16 (9th Cir. 1998). What effect, if any, *Bosch* has outside the context of the estate tax statute is unclear. The Fifth Circuit has held that "[t]he relevance of a state court's judgment to the resolution of a federal tax question will vary, depending on the particular tax statute involved as well as the nature of the state proceeding that produced the judgment." *Estate of Warren v. Comm'r,* 981 F.2d 776, 781 (5th Cir. 1993) (quoting *Brown v. United States,* 890 F.2d 1329, 1342 (5th Cir. 1989)).

Supreme Court precedent pre- and post-*Bosch* suggests that its holding does not apply outside of the estate-tax context. In *Aquilino v. United States,* 363 U.S. 509 (1960), the Court made the following observation:

> It is suggested that the definition of the taxpayer's property interests should be governed by federal law, although supplying the content of this nebulous body of federal law would apparently be left for future decisions. We think that this approach is unsound because it ignores the long-established role that the States have played in creating property interests and places upon the courts the task of attempting to ascertain a taxpayer's property rights under an undefined rule of federal law. It would indeed be anomalous to say that the taxpayer's "property and rights to property" included property in which, under the relevant state law, he had no property interest at all.

Id. at 513 n.3. More recently, in *United States v. Craft,* 535 U.S. 274 (2002), the Court held that "[s]tate law determines only which sticks are in a person's bundle. Whether those sticks qualify as 'property' for purposes of the federal tax lien statute is a question of federal law." *Id.* at 278-79; *see also Pahl v. Comm'r,* 150 F.3d 1124, 1128 (9th Cir. 1998) (holding that "we look to federal law to determine what interest creates tax liability. We look, however, to state law to determine whether the taxpayer has the requisite interest.").

Even assuming that the state court judgment is binding as to the ownership of the funds, the question becomes what the state court judgment determined. At a minimum, the state court determined that the money Boulware transferred to Lee was not a gift. The money could still be income to Boulware, however, if he gave it to Lee to hold for him in an effort to hide it from the IRS. *See Chism v. Comm'r,* 322 F.2d 956, 959-60 (9th Cir. 1963) (holding that the tax court did not err in refusing to be bound by a state court determination that withdrawals

from a closely-held corporation were loans and not dividends, because "it is not the existence of a legal obligation to repay that is controlling"; rather, whether a withdrawal is a loan "is a factual question 'to be determined upon consideration of all the circumstances present in a particular case, and depends upon the existence of an intent at the time the withdrawal is made that it should be paid back.'" (quoting *Clark v. Comm'r*, 266 F.2d 698, 710-11 (9th Cir. 1959))).

Boulware argues that the state court finding that Lee was holding the money in trust for HIE is also binding. The state court did find that the money in question belonged to HIE and that Lee had been and was holding it in "constructive trust" for HIE. On the other hand, although the record from the state court action is not part of the record on appeal, the ownership of the money as between Boulware and HIE does not appear to have been subject to adversarial testing. The special verdict form asked the jury to determine ownership only as between Lee and HIE, presumably because Boulware never claimed the money was his. If Lee maintained that she had received the money as a gift, and Boulware contended that he had given her the money to hold in trust for HIE, there would have been no reason to ask the jury if Boulware owned the money, because it was not an issue in the lawsuit.

For these reasons, we hold that the district court did not err in ruling that the state court judgment does not have preclusive effect as to the ownership of the monies.

b. *Was the State-Court Judgment Admissible Evidence?*

(1) *Relevance*

Even though the state court judgment did not have preclusive effect, the question still remains whether it was admissible evidence that the district court improperly excluded. The district court excluded the state court judgment pursuant to Federal Rules of Evidence 401 and 402, stating that whether the transfers to Lee were gifts "is not relevant to the ultimate issues of the case." This ruling was erroneous. Evidence is relevant if it has "any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Fed. R. Evid. 401. Whether Boulware transferred the HIE funds to Lee for personal purposes or for her to hold in trust for HIE was a key issue in the case. That he pursued a successful litigation against Lee to force her to return the monies to HIE has some tendency to make it more likely that he gave the monies to her to hold in trust. Indeed, the government conceded at oral argument that the state court judgment is relevant.[3]

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[3] The dissent's argument that the judgment "does not prove, or even tend to prove" that Boulware did not siphon off the money from HIE is mistaken, both legally and factually. For evidence to be relevant, and thus admissible, Rule 401 does not require that it "prove" anything. Rule 401's only requirement is that the proffered evidence have a *tendency* to prove a fact in issue and the judgment certainly has *some* tendency to make Boulware's explanation (that he gave the money to Lee to hold in trust for HIE) more probable and the government's theory of the case (that he simply gave the money to Lee) less probable. Rule 401 requires no more.

(2) *Hearsay*

Hearsay is "a statement other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted." Fed. R. Evid. 801(c). A prior judgment is therefore hearsay to the extent that it is offered to prove the truth of the matters asserted in the judgment. A prior judgment is not hearsay, however, to the extent that it is offered as legally operative verbal conduct that determined the rights and duties of the parties. *See United States v. Pang,* 362 F.3d 1187, 1192 (9th Cir. 2004). Although Rule 803 contains exceptions for certain kinds of judgments, such as judgments of previous felony convictions and judgments as to personal, family, or general history or boundaries, *see* Fed. R. Evid. 803(22) & (23), civil judgments do not fit comfortably into any hearsay exception.[4]

Boulware argues that the state court judgment fits the exceptions set forth in Rule 803(14) and (15). The first of these exceptions concerns records of documents that affect an interest in property, and reads as follows:

> **Records of documents affecting an interest in property.** The record of a document purporting to establish or affect an interest in property, as proof of the content of the original recorded

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[4] Certain kinds of judgments fall under statutory or common law exceptions. *See, e.g.,* 15 U.S.C. § 16(a) (providing that "[a] final judgment or decree heretofore or hereafter rendered in any civil or criminal proceeding brought by or on behalf of the United States under the antitrust laws to the effect that a defendant has violated said laws shall be prima facie evidence against such defendant in any action or proceeding brought by any other party against such defendant under said laws as to all matters respecting which said judgment or decree would be an estoppel as between the parties thereto").

> document and its execution and delivery by each person by whom it purports to have been executed, if the record is a record of a public office and an applicable statute authorizes the recording of documents of that kind in that office.

Fed. R. Evid. 803(14).

In *United States v. Perry,* 857 F.2d 1346 (9th Cir. 1988), a criminal tax prosecution, the government introduced testimony regarding a bankruptcy court's determination that certain transfers of property were fraudulent conveyances. *Id.* at 1351. We held that admission of the testimony was not plain error:

> The challenged testimony was not, as Perry urges, offered as substantive proof of a fraudulent scheme. A review of the record shows that the testimony was offered only to show that Perry was the true owner of certain properties nominally owned by his relatives. *See Greycas, Inc. v. Proud,* 826 F.2d 1560, 1567 (7th Cir. 1987) . . . ("a judgment, insofar as it fixes property rights, should be admissible as the official record of such rights, just like other documents of title"). This evidence, in turn, was relevant to prove that Perry had concealed his assets. From it, the jury could infer that Perry had intended to evade federal income taxes, charges for which he was on trial.

Id. at 1351-52 (footnote and ending citation omitted). Similarly, in *Greycas, Inc. v. Proud,* 826 F.2d 1560 (7th Cir. 1987), a case on which *Perry* relied, the Seventh Circuit noted that the state court judgment at issue in the case should be admissible under Rule 803(14) to show the priority of liens, "fix[ing] Greycas's rights, equivalent to

title, in Crawford's farm machinery." *Id.* at 1567 (citing Rule 803(14)).

Thus, *Perry* supports the proposition that a previous judgment is admissible under Rule 803(14) to show the ownership of assets. To the extent that Boulware offered the judgment simply for the purpose of establishing HIE's ownership of the funds in 1997 and Lee's legal obligation to return those funds, he was offering the judgment not for the truth of the matters asserted in the judgment, but rather to establish the judgment's legal effect. As this is a nonhearsay purpose, we see no need to resort to the hearsay exception set forth in Rule 803(14).

Moreover, to the extent that Boulware offered the judgment for the truth of the matters asserted – to establish that he had not gifted the funds to Lee and that she was and had been holding them in constructive trust for HIE – the judgment meets the exception set forth in Rule 803(15):

> **Statements in documents affecting an interest in property.** A statement contained in a document purporting to establish or affect an interest in property if the matter stated was relevant to the purpose of the document, unless dealings with the property since the document was made have been inconsistent with the truth of the statement or the purport of the document.

The Federal Rules of Evidence are an act of Congress, and we must therefore interpret Rule 803(15) as we would a statute, *see Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 587 (1993), in accordance with its plain meaning, *see Bourjaily v. United States*, 483 U.S. 171, 178-79 (1987) (interpreting Rule 104 in accordance with its

plain meaning); *see also Garcia v. United States,* 469 U.S. 70, 75 (1984) (noting that "only the most extraordinary showing of contrary intentions from [the legislative history] would justify a limitation on the 'plain meaning' of the statutory language").

Under the plain meaning of Rule 803(15), hearsay statements are admissible if they are contained within a document that affects an interest in property, if the statements are relevant to the purport of the document, and if dealings with the property since the document was made have not been inconsistent with the truth of the statements. *See Silverstein v. Chase,* 260 F.3d 142, 149 (2d Cir. 2001). Here, the state court judgment meets each of these requirements. The judgment affected an interest in property by declaring HIE to be the legal owner of the funds and by requiring Lee to return them to HIE, and the statements are relevant to the purport of the document. In addition, there is no indication that the parties acted inconsistently with the judgment; it was undisputed that the judgment was valid and could be authenticated.

The legislative history is not clearly to the contrary. The Advisory Committee's note to Rule 803(15) explains that "[d]ispositive documents often contain recitals of fact" and that "[u]nder the rule, these recitals are exempted from the hearsay rule." Although the note uses the example of a deed, a judgment that establishes the ownership of disputed items of property is no less of a dispositive document, and the judgment's recital of facts is no less exempt from the hearsay rule. For these reasons, we hold that the state court judgment was admissible under Rule 803(15) as a document that affected an interest in property.

Finally, the district court excluded on relevance grounds not only the state court judgment and testimony about the judgment, but also testimony about the underlying lawsuit between Lee and Boulware. For example, the court would not allow Boulware's tax attorney to testify about the lawsuit for the nonhearsay purpose explaining why he had advised Boulware not to list the monies transferred to Lee as income. For all of the reasons discussed above, the hearsay rule did not prohibit Boulware from introducing the state court judgment or testimony about the underlying lawsuit.

(3) *Rule 403*

In its motion in limine to exclude the state court judgment, the government argued that the judgment was unreliable, and admitting the judgment would confuse the jury and would lead to a mini-trial to show the deficiencies in the evidence considered in the state case.

At a minimum, the state court's finding that HIE owned the money in 1997 was relevant to show that HIE had owned the money all along and to rebut the government's suggestions that Boulware had concocted the whole "Lee as trustee" story to defend himself in the criminal prosecution.[5] Any danger that the jury would have given undue weight to the state court judgment could have been dealt with by a cautionary instruction. Likewise, even if introduction of the judgment would have led the prosecution to cross-examine witnesses about deficiencies in the

[5] The prosecutor argued, for example, that there was no evidence that Boulware owed his wife anything "except in the rather fertile imagination of [his counsel]."

evidence heard by the state court jury, the trial judge should easily have been able to control any waste of time or confusion of the issues, so that admission of the state court judgment would not have substantially outweighed the probative value of the evidence.[6]

(4) *Harmless Error*

Although it was error to exclude the state court judgment, the error is not reversible if it was harmless. If the error amounts to a constitutional violation, we apply the "harmless beyond a reasonable doubt" standard. *See Chapman v. California,* 386 U.S. 18, 24 (1967).

"[N]ot every hearsay error amounts to a constitutional violation. At a minimum, a defendant must demonstrate that the excluded evidence was important to his defense." *United States v. Lopez-Alvarez,* 970 F.2d 583, 588 (9th Cir. 1992); *see also United States v. Saenz,* 179 F.3d 686, 689 (9th Cir. 1999) (holding that "[e]rror cannot be harmless where it prevents the defendant from providing an evidentiary basis for his defense"). Here, the state-court judgment was crucial to Boulware's defense on the tax counts, and the judgment directly contradicted the government's theory of the case. The district court's exclusion of the

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[6] The dissent "would hold that the district court did not abuse its discretion in ruling the Hawaiian judgment inadmissible," based on its belief that the district court conducted an "[i]mplicit . . . evaluation of probative value." The district court, however, did not perform a Rule 403 balancing analysis; rather, it simply held that the evidence was "not relevant to the ultimate issues of the case" and granted the government's motion to exclude the judgment "pursuant to Rules 401 and 402 of the Federal Rules of Evidence." We therefore review de novo, rather than for abuse of discretion, whether the judgment was properly excludable under Rule 403.

judgment denied Boulware "a meaningful opportunity to present a complete defense," *Lopez-Alvarez,* 970 F.2d at 587-88, and thus violated his due process rights. We must therefore reverse unless the error was harmless beyond a reasonable doubt.

The government argues that the error was harmless because Boulware himself testified on direct examination about the judgment.[7] Boulware makes the point, however, that he was the least effective witness to testify about the judgment because of his perceived self-interest and bias. In addition, although he called witnesses who testified that HIE at all times owned the funds that he transferred to Lee and that he relied in good faith on the advice of his lawyer and accountants in not reporting the funds on his

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[7] Boulware's testimony on this subject was as follows:

Q. So, during that time period, in the spring of '94, after you got your divorce, did Jin Sook Lee agree to return the company's money to HIE?

A. No.

Q. Did you end up in lawsuits with Jin Sook Lee to force her to return the money?

A. Yes.

Q. And then approximately in 1997, was Jin Sook Lee forced to return money to the company?

A. Yes.

Q. Approximately how much?

A. Five, six million.

Q. I'm sorry?

A. Five, six million.

Q. But during the time period from 1994 to '97, the company didn't receive its money back from Jin Sook Lee, did it?

A. No.

tax returns, he points out that the prosecution sharply attacked the credibility of these witnesses, and the judgment would have been key corroborative evidence.

Another reason the exclusion of the state court judgment may have been harmless is that Boulware's story was somewhat implausible. Rather than setting up a formal arrangement by which money would be held in trust to buy out his wife's interest in HIE, Boulware gave corporate money to his girlfriend. In addition, he transferred the money to her in a series of shady transactions. Rather than putting the cash in a bank account so that it could earn interest, Lee held the cash in a safe in their home. Finally, Boulware did not sue Lee for a return of the funds until she sued him.

Nevertheless, the beneficial ownership of the funds that Boulware transferred to Lee was central to the entire case against him, and the government did not call Lee or any other witness to rebut Boulware's claim that he gave the money to her to hold in trust for the purchase of his ex-wife's marital interest.[8] Boulware's attorney Michael McCarthy testified that in 1987 Boulware retained him to establish a trust for Boulware and Lee's nonmarital son, Glenn Lee Boulware. Half of the shares of HIE were put into the trust. McCarthy advised Boulware that Lee, as the trustee of a trust that held a 50% ownership interest in HIE, would be a constructive trustee of any assets she received that belonged to HIE. He advised Boulware that

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[8] The government did call Boulware's ex-wife, Mal Sun Boulware, to the stand, but she did not necessarily help the government's case. On cross-examination, she confirmed that when Boulware asked her for a divorce in 1987, she demanded $5 million and a $1 million house because she believed she had an ownership interest in HIE.

any HIE property given to Lee would continue to belong to HIE, and would never belong to Lee or Boulware.

In the end, we are not convinced beyond a reasonable doubt that the jury would have arrived at the same verdict had testimony regarding the state court judgment and the judgment itself not been excluded. We therefore reverse Boulware's convictions on all of the tax evasion and false tax return counts and remand for a new trial.

B. Sufficiency of the Evidence

Boulware also contends that we must reverse his convictions for filing false tax returns and tax evasion because the government failed to prove that he underreported his income. Although we reverse Boulware's conviction, we must still consider his contention that the evidence was insufficient to sustain his conviction, because a challenge to the sufficiency of the evidence implicates a defendant's rights under the Double Jeopardy Clause. *See United States v. Recio,* 371 F.3d 1093, 1104 (9th Cir. 2004); *United States v. Gergen,* 172 F.3d 719, 724-25 (9th Cir. 1999).

1. Standard of Review

Where, as here, the defendant made timely motions for acquittal, we review his insufficiency of the evidence claim de novo. *United States v. Odom,* 329 F.3d 1032, 1034 (9th Cir. 2003). We will deny the claim if, viewing the evidence in the light most favorable to the prosecution, any rational trier of fact could have found the elements of the crime proved beyond a reasonable doubt. *Id.*

2. Analysis

Boulware was convicted on counts 1-5 of filing false tax returns in violation of 26 U.S.C. § 7206(1) for the 1989-1993 tax years. He was also convicted on renumbered counts 6-9 of tax evasion in violation of 26 U.S.C. § 7201 for the 1994-1997 tax years.

The elements of the offense of filing false tax returns under § 7206(1) are as follows:

> (1) the defendant made and subscribed a return, statement, or other document that was incorrect as to a material matter; (2) the return, statement, or other document subscribed by the defendant contained a written declaration that it was made under the penalties of perjury; (3) the defendant did not believe the return, statement, or other document to be true and correct as to every material matter; and (4) the defendant falsely subscribed to the return, statement, or other document willfully, with the specific intent to violate the law.

United States v. Marabelles, 724 F.2d 1374, 1380 (9th Cir. 1984). The elements of tax evasion under § 7201 are "(1) the existence of a tax deficiency, (2) willfulness in attempted evasion of taxes, and (3) an affirmative act constituting an evasion or attempted evasion." *Id.* at 1377-78.

Boulware's convictions under §§ 7206(1) and 7201 hinge on the fact that he diverted funds from HIE but did not report them as income on his personal income tax returns. Boulware argues that although he controlled the funds in question, the government introduced no evidence that this control was inconsistent with ownership of the funds by HIE. Although the government argued to the jury that Boulware "stole" the money from HIE, the government

did not establish any of the required elements of theft under Hawaii law. Finally, he argues, the diversions could not have constituted taxable constructive dividends, because HIE had no positive earnings or profits during the years charged in the indictment.

The sufficiency of the evidence issue boils down to whether the government could have proved the elements of §§ 7206(1) and 7201 beyond a reasonable doubt without proving either that Boulware stole the funds from HIE or that the funds were not loans or nontaxable returns of capital. *United States v. Miller,* 545 F.2d 1204 (9th Cir. 1976), indicates that the answer to this question is "yes."

Miller, like this case, concerned the characterization of funds that a taxpayer diverted from his closely-held corporation. *Id.* at 1211. The defendant argued that his conviction for tax evasion could not stand, because the government had not proved that his corporation had any earnings and profits during the years in question. *Id.* at 1210. Therefore, his diversions must be treated as a return of capital. *Id.* at 1210-11. The court rejected this argument, stating that "[i]n a criminal tax proceeding the concern is not over the type or the specific amount of the tax which the defendant has evaded, but whether he has willfully attempted to evade the payment or assessment of a tax." *Id.* at 1214. The court also held that the defendant had the burden of going forward once the government "demonstrates that the taxpayer had unexplained funds which *could be considered* as income which the taxpayer fails to report in his return." *Id.* at 1215 & n.13 (emphasis added).

Boulware counters that the government did not make out a prima facie case on the false tax return and tax

evasion counts because it used a bank-deposits method of proof and failed to investigate leads that were reasonably susceptible of being checked. In particular, HIE's comptroller testified to the grand jury that HIE had fully reported the $10.2 million at issue and submitted records in support of this contention. In addition, the government knew of a bankruptcy action in which the court affirmed the trustee's determination that assets held by Lee belonged to HIE.

The theory behind the bank-deposits method of proof was described long ago, as follows:

> [I]f it be shown that a man has a business or calling of a lucrative nature and is constantly, day by day and month by month, receiving moneys and depositing them to his account and checking against them for his own uses, there is most potent testimony that he has income, and, if the amount exceeds exemptions and deductions, that the income is taxable.

Gleckman v. United States, 80 F.2d 394, 399 (8th Cir. 1935) (quoted in 2 Kenneth E. North, *Criminal Tax Fraud* § 23.41, at 405 (3d ed. 1998)). When using the bank-deposits method of proof, the government must conduct an adequate and full investigation to remove non-income deposits, such as transfers between bank accounts. *United States v. Stone,* 770 F.2d 842, 844 (9th Cir. 1985). "The critical question is whether the government's investigation has provided sufficient evidence to support an inference that an unexplained excess in bank deposits is attributable to taxable income." *Id.* at 844-45. Although the government must be especially thorough in its investigation and presentation, "it is well settled that the government is not obliged to prove the exact amount of a deficiency so long as

the taxpayer's understatement of income is substantial." *Id.* at 845.

Here, the government witness who performed the bank-deposits analysis, Jerry Yamachika, testified that he "eliminated . . . any loans that may have come – that Mr. Boulware might have gotten from his company. . . ." On cross-examination, Yamachika testified that he credited Boulware with deductions for money in the bank accounts that was used to buy coffee, and that "an analysis was done as to what credit he was given on his loan account at the corporation to reduce his loan for the purchases he made." Based on the testimony at trial, "[t]he evidence was more than adequate to support the inference that the defendant's bank deposits were income from [HIE] and were in fact currently taxable but unreported income." *Id.* at 845.

Boulware argues that even if the government did make out a prima facie case, he met his burden of going forward with the evidence by testifying that the diversions were loans and were accounted for as such on HIE's books. This put the burden back on the government to prove the deposits were not loans. The nature of the transactions, however, was sufficient evidence for a rational juror to conclude beyond a reasonable doubt that the deposits were not loans.

We conclude that there was ample evidence from which a rational juror could have concluded that Boulware was guilty of willfully submitting false tax returns for the 1989-1993 tax years and of willfully evading taxes for the 1994-1997 tax years.

C. Other Asserted Trial Errors

Boulware further contends that his conviction should be reversed because of a number of asserted trial errors, including constructive amendment of the indictment by the prosecutor and prosecutorial misconduct. Most of these errors, however, were not objected to at trial; therefore, we would review them under the plain error rule of Fed. R. Crim. P. 52(b). *See, e.g. United States v. Dipentino,* 242 F.3d 1090, 1094 (9th Cir. 2001). We see no useful purpose in reviewing these asserted errors. First, a ruling under plain error review will give the district court little assistance on retrial on how it should rule if a timely objection is made. Second, we will not assume that any trial error is likely to be repeated in a retrial.

We briefly address Boulware's Confrontation Clause claim, however, because it relates directly to his conviction for conspiracy to make false statements to a federally-insured financial institution. Boulware contends that the district court violated his rights under the Confrontation Clause by limiting his cross-examination of Lorin Kushiyama, his alleged co-conspirator on count 10. Whether limitations on cross-examination violate the Confrontation Clause is a question that we review de novo. *United States v. Adamson,* 291 F.3d 606, 612 (9th Cir. 2002).

Boulware argues that the district court would not allow him to cross-examine Kushiyama about whether he agreed with Boulware to submit fraudulent invoices, an essential element of the conspiracy charge. The district court sustained a string of objections on relevance grounds to questions regarding whether Kushiyama had prepared invoices or appraisals for *other parties.* When defense counsel asked Kushiyama "As far as these invoices, you

are not the – intending to submit fake invoices to anyone, were you?," the judge sustained the government's objection and defense counsel did not pursue the matter further.

Although it is not completely clear whether "these invoices" referred to those prepared for Boulware or to ones prepared for other customers, the court was obviously under the impression that they referred to invoices for other parties and defense counsel did nothing to disabuse him of this impression. Defense counsel did not reword the question, explain to the court that he was inquiring about the invoices at issue in this case, or call Kushiyama as a defense witness.

For these reasons, the limitation on the cross-examination of Kushiyama was not so severe as to amount to a violation of Boulware's Confrontation Clause rights.

D. Sentencing Issues

Among other sentencing issues, Boulware contends that the district court erred in its calculation of the tax loss attributed to his offense, including the court's failure to hold an evidentiary hearing. In its cross-appeal the government contends that the district court erred in declining to enhance Boulware's sentence for obstruction of justice. Given our reversal and remand for a new trial on the tax counts, no purpose would be served by our review of the sentencing issues.

Sentence was imposed in this case well before *Blakely v. Washington,* 124 S.Ct. 2531 (2004), wrought a sea change in sentencing, and *United States v. Ameline,* 376 F.3d 967 (9th Cir. 2004), held that *Blakely* was applicable to certain aspects of sentencing under the U.S. Sentencing

Guidelines.[9] Under these circumstances, because we are reversing and remanding for a new trial on most counts, in the event there is a conviction (and in any event on the remaining, unreversed count) when the district court resentences Boulware, it will be under the then extant post-*Blakely* regime.

We must, however, address Boulware's challenge to the district court's forfeiture order, because we affirm his conviction for conspiracy to make false statements to a federally insured financial institution and because Boulware waived his right to a jury determination of the forfeiture issue.

Boulware argues that the district court's forfeiture order was erroneous, because it did not give him credit for funds he returned to the lender. The jury convicted Boulware of renumbered count 10 of the indictment, conspiracy to make false statements to a federally-insured financial institution, but acquitted him of the substantive charges (counts 11-14). Renumbered count 15 of the indictment charged that Boulware shall forfeit proceeds that he obtained directly or indirectly as a result of the offenses charged in counts 10-14.

18 U.S.C. § 982(a)(2) provides:

> The court, in imposing sentence on a person convicted of a violation of, or a conspiracy to violate –

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[9] The Supreme Court has granted certiorari in two cases, *United States v. Booker*, 2004 WL 1713654 (U.S. Aug. 2, 2004), and *United States v. Fanfan*, 2004 WL 1713655 (U.S. Aug. 2, 2004), which present the question of *Blakely's* application to the U.S. Sentencing Guidelines.

> (A) section . . . 1014 . . . of this title, affecting a financial institution . . .
>
> * * *
>
> shall order that the person forfeit to the United States any property constituting, or derived from, proceeds the person obtained directly or indirectly, as the result of such violation.

Nothing in the text of the statute entitles Boulware to a set-off for loan proceeds that he repaid to GECC. In fact, § 982(b)(1) incorporates the provisions of 21 U.S.C. § 853(c), which provides that "[a]ll right, title, and interest in property described in subsection (a) of this section vests in the United States upon the commission of the act giving rise to forfeiture under this section." Finally, that defendants may be required to pay restitution and forfeit the same amounts indicates that Boulware is not entitled to receive a credit for funds he returned. *Cf. United States v. Bright*, 353 F.3d 1114, 1125 (9th Cir. 2004) (holding that forfeited funds need not be applied toward restitution); *United States v. Feldman*, 853 F.2d 648, 663-64 (9th Cir. 1988) (holding that the sentencing option of ordering restitution "is not denied to the district court because a defendant must also forfeit the proceeds of illegal activity").

The district court did not err in failing to reduce the amount of the forfeiture. The criminal forfeiture statute contains nothing comparable to the civil forfeiture statute's provision that "[i]n cases involving fraud in the process of obtaining a loan or extension of credit, the court shall allow the claimant a deduction from the forfeiture to the extent that the loan was repaid, or the debt was satisfied, without any financial loss to the victim," Civil

Asset Forfeiture Reform Act of 2000, Pub. L. 106-185, 114 Stat. 202, § 20(b), *codified at* 18 U.S.C. § 981(a)(2)(C).

IV

We reverse Boulware's conviction for tax evasion and filing false tax returns and affirm his conviction for conspiracy to make false statements to a federally-insured financial institution. We vacate his sentence on the false statement count and remand for further proceedings consistent with this opinion.

AFFIRMED in part, REVERSED in part, and REMANDED.

SILVERMAN, Circuit Judge, dissenting:

In my view, the district court did not abuse its discretion in refusing to admit the state court judgment into evidence. The judgment does no more than establish that, as between Jin Sook Lee and Hawaiian Isles Enterprises, the money belonged to Hawaiian Isles Enterprises. This has no bearing on whether Boulware diverted corporate funds to his girlfriend for his own benefit without paying tax on the money. The judgment establishes only that *she* was not entitled to keep the cash. It does not prove, or even tend to prove, that *he* didn't siphon off the money from the corporation, tax-free. Why would it? That was not at issue in the case.

District courts have wide latitude in ruling on the relevancy of evidence. *United States v. Alvarez*, 358 F.3d 1194, 1216 (9th Cir. 2004). Implicit in any such ruling is an evaluation of probative value. 1 McCormick on Evidence § 185, at 637 (5th ed. 1999) ("There are two components to relevant evidence: materiality and probative

value."). Because the state court judgment against Lee sheds little if any light on whether Boulware committed tax evasion, I would hold that the district court did not abuse its discretion in ruling the Hawaiian judgment inadmissible. I would affirm the district court and, therefore, respectfully dissent.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA, Plaintiff-Appellee, v. MICHAEL H. BOULWARE, Defendant-Appellant.	No. 05-10752 D.C. No. CR-99-0239-ER ORDER DENYING PETITION FOR REHEARING EN BANC (Filed Apr. 23, 2007)

Before: RYMER and THOMAS, Circuit Judges, and LARSON,*

The panel has unanimously voted to deny the appellant's Petition for Rehearing. The Petition for Rehearing En Banc was circulated to the judges of the court, and no judge requested a vote for en banc consideration.

The petition for rehearing and the petition for rehearing en banc are DENIED.

* The Honorable Stephen G. Larson, United States District Judge for the Central District of California, sitting by designation.

Supreme Court, U.S.
FILED
JUL 16 2007
OFFICE OF THE CLERK

No. 06-1509

In the Supreme Court of the United States

MICHAEL H. BOULWARE, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals erred in finding that a state-court jury verdict did not resolve the question whether corporate funds in the possession of petitioner's girlfriend belonged to petitioner.

2. Whether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a non-taxable return of capital up to the shareholder's stock basis, see 26 U.S.C. 301(c)(2), even if the diversion was not intended as a return of capital.

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinions of the court of appeals (Pet. App. 1-14, 27-61) are reported at 470 F.3d 931 and 384 F.3d 794, respectively.

JURISDICTION

The judgment of the court of appeals was entered on December 13, 2006. A petition for rehearing was denied on April 23, 2007 (Pet. App. 63). The petition for a writ of certiorari was filed on May 11, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the District of Hawaii, petitioner was convicted on five counts of filing false tax returns, in viola-

tion of 26 U.S.C. 7206(1), four counts of tax evasion, in violation of 26 U.S.C. 7201, and one count of conspiring to make a false statement to a federally insured financial institution, in violation of 18 U.S.C. 371. The court of appeals, in a prior appeal, affirmed the conspiracy conviction but reversed the tax convictions and remanded for a new trial. Pet. App. 27-61. This Court denied a petition for a writ of certiorari. 546 U.S. 814 (2005).

On remand, petitioner again was found guilty by a jury on the tax counts, and he was sentenced to 36 months of imprisonment on the tax return counts and 60 months on the tax evasion and conspiracy counts, to run concurrently. Pet. App. 2. On a second appeal, the court of appeals affirmed both the convictions and sentence. *Id.* at 1-12.

1. Petitioner is the founder, former president, and majority owner of a closely held corporation, Hawaiian Isles Enterprises (HIE), that deals in tobacco distribution, coffee processing and sales, arcade games, vending machines, and bottled water. A trust for the benefit of petitioner's son also owns stock in the corporation. Following a six-year investigation, the Internal Revenue Service (IRS) determined that petitioner had diverted more than $10 million from HIE and failed to report or pay taxes on that income. The scheme involved a variety of devices. Petitioner diverted at least $3.6 million by giving HIE checks to friends and employees and instructing them to cash the checks, then return the cash to petitioner. He diverted another $3.58 million by establishing two bank accounts in HIE's name but under petitioner's exclusive control, then depositing proceeds from HIE sales into the accounts without recording the sales on HIE's books. Petitioner also diverted HIE funds by instructing businesses that purchased coffee

from HIE to remit payment directly to petitioner and by using false invoices to obtain a loan from a federally insured bank. He laundered the money through companies in the Kingdom of Tonga and Hong Kong, and used the diverted funds to support a lavish lifestyle, giving millions of dollars in HIE funds to his girlfriend, Jin Sook Lee, as well as his wife, Mal Sun Boulware. Pet. App. 2-3, 29-30; Gov't C.A. Br. 5-9 & n.3.

2. In 1994, Lee filed a complaint against petitioner and HIE in Hawaii state court, alleging, inter alia, that petitioner had taken $840,000 in cash from a safe in her home and had wrongfully acquired real property belonging to her. Pet. App. 33-34. Petitioner and HIE filed counterclaims seeking the return of approximately $5 million in corporate funds, paid to Lee in anticipation of petitioner's divorce settlement. According to petitioner and HIE, Lee had "promised to hold [the funds] for the benefit of [HIE] * * * and to reconvey them to [petitioner and HIE] upon demand." *Id.* at 35 (second set of brackets in original). Petitioner and HIE sought a declaration "that the transfers to Lee were not gifts." *Ibid*

In 1997, the state-court action proceeded to trial. The jury returned a special verdict form, finding that the monies were not "gifts to Jin Sook Lee," but instead "belong[ed] to Hawaiian Isle Enterprises." Pet. App. 32, 36. On equitable claims tried before the judge, the court awarded HIE a judgment of more than $4.5 million, finding that that amount "has been and is being held in constructive trust" for HIE. *Ibid.*

3. In 2000, a federal grand jury returned a superseding indictment charging petitioner with nine counts of filing false tax returns, four counts of tax evasion, four counts of making false statements to a federally insured financial institution, and one count of conspiracy to make

such false statements. Pet. App. 29. Petitioner ultimately was convicted on four counts of filing a false tax return, four counts of tax evasion, and the conspiracy count. He was acquitted on the four counts of making false statements. *Ibid.*

4. On appeal, the court of appeals affirmed petitioner's conviction on the conspiracy count, but reversed his conviction on the tax counts and remanded for further proceedings. Pet. App. 27-61.

Petitioner challenged his conviction on the tax counts on the ground that the state-court judgment had conclusively determined that the funds delivered to Lee belonged at all times to HIE, and therefore could not have been taxable income to petitioner. Pet. App. 36, 39. The court of appeals rejected that claim, reasoning that, "[e]ven assuming that the state court judgment is binding as to the ownership of the funds, the question becomes what the state court judgment determined." *Id.* at 41. The court noted that, although the state-court judgment included findings that the monies "belonged to HIE" and that Lee "had been and was holding it in 'constructive trust' for HIE," the ownership of the money "as between [petitioner] and HIE" was not at issue in the case, and "does not appear to have been subject to adversarial testing." *Id.* at 42. The court of appeals construed the special verdict form as asking the jury to determine ownership "only as between Lee and HIE, presumably because [petitioner] never claimed the money was his." *Ibid.* Accordingly, the court of appeals found that the district court did not err in ruling that the state-court judgment did not conclusively determine that HIE, rather than petitioner, owned the funds diverted to Lee. *Ibid.*

Nonetheless, the court of appeals vacated petitioner's conviction on the tax counts and remanded for a new trial, holding that the district court had erred in excluding the state-court judgment from evidence. According to the court of appeals, the state-court judgment was at least minimally relevant to the ownership of the funds, and that error was not harmless. Pet. App. 43-52. Judge Silverman dissented from that determination (*id.* at 61-62), arguing that the district court did not abuse its discretion in refusing to admit the state-court judgment because the judgment "has no bearing on whether [petitioner] diverted corporate funds to his girlfriend for his own benefit without paying tax on the money," and instead established "only that *she* was not entitled to keep the cash." *Id.* at 61.

The court of appeals also considered petitioner's challenge to the sufficiency of the evidence on the tax counts. Pet. App. 52. Petitioner contended that the government had failed to establish the existence of a tax deficiency because it failed to prove, beyond a reasonable doubt, that the corporate funds petitioner diverted for his personal use did not constitute non-taxable returns of capital under 26 U.S.C. 301(c)(2). The court of appeals rejected that argument based on its decision in *United States* v. *Miller*, 545 F.2d 1204, 1214 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977), which held that once the government establishes a prima facie case that the defendant received and failed to report unexplained corporate funds, the burden shifts to the defendant to establish that the funds were intended as a non-taxable return of capital. Pet. App. 54. The court of appeals held that the government had provided "ample evidence," based on the nature of the transactions, from which a rational juror could have determined that the

deposits were not loans and that petitioner was guilty of tax evasion and willfully submitting false tax returns. *Id.* at 56.

5. On May 2, 2005, petitioner filed a petition for a writ of certiorari (No. 04-1468). He renewed his claim that the state-court judgment had conclusively determined that HIE owned the funds, and urged this Court to review the application of *Commissioner* v. *Estate of Bosch*, 387 U.S. 456 (1967) (*Bosch*), outside the estate-tax context. The government opposed the petition, arguing that because "[t]he dispute in the Hawaii case was whether Lee had received the money as a gift or whether she had been given the money to hold in trust for HIE," the jury "determined only that HIE had a better claim to the money than Lee did" and "did not determine whether the money belonged to HIE or petitioner." Br. in Opp. at 7, *Boulware* v. *United States*, *supra* (No. 04-1468). On October 3, 2005, this Court denied the petition. 546 U.S. 814 (2005).

6. After a retrial on the tax charges, a jury again found petitioner guilty on four counts of tax evasion and five counts of filing a false income tax return. The district court imposed concurrent sentences of 36 months of imprisonment on the false return counts and 60 months of imprisonment on the tax evasion and conspiracy counts. Pet. App. 2.

7. The court of appeals affirmed both the convictions and sentence. Pet. App. 2. Renewing the argument he pressed in his first appeal and petition for a writ of certiorari, petitioner argued that the state-court judgment had conclusively determined that the funds held by Lee belonged at all times to HIE, and therefore were not taxable as income to petitioner. *Id.* at 11. The court of appeals rejected that argument, holding that the prior

appeal had established the law of the case on that issue. *Id.* at 11-12.

Petitioner also argued that the district court erred in excluding evidence that, according to petitioner, would have shown that HIE lacked earnings and profits and that the funds he took from HIE were therefore non-dividend returns of capital, not subject to taxation. Pet. App. 3. The court of appeals (*id.* at 6), again citing *Miller*, 545 F.2d at 1215 & n.13, held that "once the government has shown that [petitioner] diverted funds from the corporation and failed to report them, the burden shifts to the taxpayer to show that the funds constituted a return of capital." Pet. App. 6. The court observed that nothing in HIE's corporate records indicated that the diverted funds were intended as a return of capital, and it held that the district court had properly rejected petitioner's proffer as inadequate. *Ibid.*

The court of appeals acknowledged that its approach in *Miller* conflicted with that of the Second Circuit, which held in *United States* v. *Bok*, 156 F.3d 157, 162 (1998), and *United States* v. *D'Agostino*, 145 F.3d 69, 72-73 (1998), that a taxpayer need not show that a distribution was intended as a return of capital when invoking the return-of-capital defense. It noted, however, that it was "by no means certain" that petitioner would prevail even under the Second Circuit's approach. Pet. App. 6.

Judge Thomas concurred, stating that if the court "were writing on a clean slate, rather than under the controlling precedent of [*Miller*]," he would have adopted the Second Circuit's reasoning. Pet. App. 13. He emphasized, however, that even under the Second Circuit's approach, "the outcome would not be affected" in this case because petitioner's diversion of funds was unlawful, and the Second Circuit has expressly held that

the return-of-capital defense is unavailable if the diversion itself was unlawful. *Id.* at 14 (citing *Bok*, 156 F.3d at 162).

Petitioner filed a petition for rehearing en banc, urging the court of appeals to abandon *Miller* and adopt the reasoning of the Second Circuit's *D'Agostino* decision. Pet. En Banc 1-2, 8-10. The court of appeals denied the petition, with no judge requesting a vote for en banc consideration. Pet. App. 63.

ARGUMENT

Petitioner renews (Pet. 7-11) his claim that the district court erred in failing to give binding effect or "proper regard" to the state-court judgment. The court of appeals correctly construed that judgment as resolving the ownership of the funds only as between HIE and Lee, not as between HIE and petitioner. Further review of that factbound determination is not warranted. Petitioner also asks this Court (Pet. 11-16) to resolve the conflict between the Second and Ninth Circuits concerning the proper application of the return-of-capital defense in criminal tax cases. As the court of appeals recognized, however, this case presents a poor vehicle for that review because petitioner cannot prevail under either approach.

1. In *Commissioner* v. *Estate of Bosch*, 387 U.S. 456 (1967), this Court considered "[w]hether a federal court or agency in a federal estate tax controversy is conclusively bound by a state trial court adjudication of property rights or characterization of property interests when the United States is not made a party to such proceeding." *Id.* at 456-457. The Court noted that Congress, in enacting the federal estate tax, had indicated "that 'proper regard,' not finality, 'should be given to

interpretations of the will' by state courts and then only when entered by a court 'in a bona fide adversary proceeding.'" *Id.* at 464 (quoting S. Rep. No. 1013, 80th Cong., 2d Sess. Pt. 2, at 4 (1948)). It also noted that under the Rules of Decision Act, 28 U.S.C. 1652, as construed in *Erie R.R.* v. *Tompkins*, 304 U.S. 64 (1938), "the decision of a state trial court as to an underlying issue of state law should * * * not be controlling" because, in the absence of a decision from the state's highest court, "federal authorities must apply what they find to be the state law" and need only give "'proper regard' to relevant rulings of other courts of the State." *Bosch*, 387 U.S. at 465. The Court therefore held that "where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such property interest by a state trial court." *Id.* at 457.

Petitioner argues (Pet. 7-9 & n.3) that *Bosch* conflicts with this Court's earlier decisions in *Blair* v. *Commissioner*, 300 U.S. 5 (1937), and *Freuler* v. *Commissioner*, 291 U.S. 35 (1934), and that *Bosch* should be limited to the estate-tax context. In the alternative, he asks this Court (Pet. 10-11) to clarify the level of deference owed to a state-court judgment under the "proper regard" standard of *Bosch*.

Neither of those questions is presented in this case. The court of appeals assumed, for purposes of petitioner's appeal, that the state-court jury verdict deserved more than "proper regard" and was binding as to the ownership of the funds. Pet. App. 41. It found, however, that the state-court judgment did not address the ownership of the funds "as between [petitioner] and HIE." *Id.* at 42. As the court of appeals recognized,

that question was not presented to the jury and "does not appear to have been subject to adversarial testing" before the state court. *Ibid.* Thus, in this case, unlike *Bosch*, "the matter decided" in state court does not resolve the question of ownership presented in federal court. 387 U.S. at 462.

Although petitioner disputes the scope of the state-court judgment, pointing to Hawaii claim-preclusion decisions (Pet. 10), resolution of that issue presents no question of national importance warranting this Court's review. This Court's "custom on questions of state law ordinarily is to defer to the interpretation of the Court of Appeals for the Circuit in which the State is located." *Elk Grove Unified Sch. Dist.* v. *Newdow*, 542 U.S. 1, 16 (2004); see *Bowen* v. *Massachusetts*, 487 U.S. 879, 908 (1988) ("We have a settled and firm policy of deferring to regional courts of appeals in matters that involve the construction of state law."). There would be even less reason for this Court to conduct plenary review of the scope of a particular state-court judgment that has been interpreted by the regional court of appeals. This Court has already denied one petition for a writ of certiorari on this issue, *Boulware* v. *United States*, 546 U.S. 814 (2005), and there is no reason for a different result here.

2. Petitioner is correct that the decision of the court of appeals in *United States* v. *Miller*, 545 F.2d 1204, 1214 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977), conflicts with the Second Circuit's decision in *United States* v. *D'Agostino*, 145 F.3d 69, 72-73 (1998). That conflict is not squarely presented in this case, however, because petitioner's conviction would be affirmed even under the Second Circuit's approach.

a. As an element of tax evasion under 26 U.S.C. 7201, the government must prove the existence of a tax

deficiency on the part of the defendant. Pet. App. 53. Section 301 of the Internal Revenue Code divides distributions of property "made by a corporation to a shareholder with respect to its stock," 26 U.S.C. 301(a), into three categories: (1) the portion of the distribution "which is a dividend (as defined in section 316)," which is taxable as gross income; (2) any non-dividend portion of the distribution, which is non-taxable to the extent it can be "applied against and reduce" the shareholder's "adjusted basis of the stock"; and (3) any non-dividend portion of the distribution "to the extent that it exceeds the adjusted basis of the stock," which is taxable as a capital gain. 26 U.S.C. 301(c)(1)-(2) and (3)(A). Section 316 in turn defines a "dividend" as a distribution made by a corporation to its shareholders "out of its earnings and profits." 26 U.S.C. 316(a)(2). Read together, those provisions establish that when a corporation distributes funds to a shareholder "with respect to its stock," the tax consequences of the distribution depend, in part, on whether the corporation has earnings and profits and the amount of the shareholder's adjusted stock basis.

In *Miller*, *supra*, the court of appeals correctly rejected the argument, pressed by petitioner here (Pet. 13), that unexplained distributions to a shareholder from a corporation without earnings and profits automatically qualify as non-taxable returns of capital up to the shareholder's stock basis, regardless of the reasons for the distribution. In that case, the president and sole shareholder of a closely held corporation failed to record more than $850,000 in corporate receipts on the corporate books, falsely recording some of the receipts as loans from the defendant to the corporation. *Miller*, 545 F.2d at 1209. Over the same period, the corporation paid virtually all of the defendant's personal expenses ("from

the mortgage on his home to his 'Book-of-the-Month' Club obligations"), and the defendant falsely characterized the expense payments as repayments of loans. *Ibid.* Following a bench trial, the district court found that the distributions were taxable as salary, and were not constructive corporate distributions under Section 301(c). *Id.* at 1212, 1215-1216.

On appeal, the court of appeals rejected the defendant's "extremely technical argument" that any diversion of corporate funds by a shareholder must automatically be treated as a return of capital if the corporation lacks earnings and profits and the shareholder has a sufficient stock basis. *Miller*, 545 F.2d at 1210. Such a rule would result in "an anomalous situation" in which "[a] taxpayer who diverted funds from his close corporation when it was in the midst of financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in the stock) for failure to report such sums as income," but "that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." *Id.* at 1214. Instead, the court held, for a diversion to qualify as a return of capital "there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return." *Id.* at 1215. "To hold otherwise," the court reasoned, "would be to permit the taxpayer to divert such funds and if not caught, to later pay out another return of capital; or if caught, to avoid conviction by raising the defense that the sums were a return of capital and hence non-taxable." *Ibid.*

The court of appeals' focus on whether the distribution was "intended to be" a return of capital, *Miller*, 545 F.2d at 1215, follows from the text of Section 301(a).

That provision states that the dividend and return-of-capital rules set forth in Section 301(c) apply only to distributions to a shareholder "with respect to its stock"—that is, distributions made *by reason of* the corporation-shareholder relationship. A distribution does not qualify as a return of capital, for example, if the corporation pays an individual shareholder in his capacity as a debtor, creditor, employee, or vendee, or under other circumstances where the individual's status as a shareholder is incidental. See 26 C.F.R. 1.301-1(c) ("Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."). By looking to evidence that the distribution was intended as a return of capital (or dividend or capital gain), rather than a payment of salary or repayment of a debt, the standard adopted by the court of appeals ensures that Section 301(c) applies only to distributions made "with respect to" the shareholder's stock. See *Loftin & Woodard, Inc.* v. *United States*, 577 F.2d 1206, 1242 (5th Cir. 1978) ("[I]nterest paid to a stockholder who is a bona fide creditor is not a dividend nor are payments made to a stockholder who is a bona fide lessor."); cf. *Elliotts, Inc.* v. *Commissioner*, 716 F.2d 1241, 1245-1248 (9th Cir. 1983) (articulating standards for determining whether payments to a shareholder-employee qualify as compensation or dividends).

b. The Second Circuit has adopted a conflicting approach. In *D'Agostino*, that court held that under the "'no earnings and profits, no income' rule" adopted by the Tax Court in *Truesdell* v. *Commissioner*, 89 T.C. 1280, 1294-1295 (1987), action on decision, AOD 1988-025, 1988 WL 570761 (IRS Sept. 12, 1988) (Action on Decision), every distribution of funds to a share-

holder from a corporation without earnings or profits qualifies as a return of capital up to the shareholder's stock basis, even if the distribution was not intended as a return of capital. *D'Agostino*, 145 F.3d at 72-73.* In *D'Agostino*, shareholders in a closely held corporation diverted more than $400,000 in corporate funds to their personal use and hid the cash in kitchen drawers. The distributions were not intended as repayments of capital; the court conceded that "[i]t is entirely possible the D'Agostinos intended to evade paying taxes." *Id.* at 73. Nonetheless, the court held that because the corporation did not have earnings or profits and the distributions did not exceed their stock basis, the distributions automatically qualified as non-taxable returns of capital. *Id.* at 72-73. The Second Circuit has since recognized that its approach conflicts with the holding of *Miller*. See *Bok*, 156 F.3d at 163 n.2.

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* Neither *Truesdell* nor the IRS's acquiescence in that decision supports the Second Circuit's rule automatically treating diversions of corporate funds to a shareholder as distributions "with respect to its stock." In *Truesdell*, the Tax Court rejected the government's argument that diverted funds are taxable as ordinary income in every case where the taxpayer exercises "dominion and control" over the funds. 89 T.C. at 1298. But the court also followed *Miller* in refusing "to apply the constructive distribution rules automatically to shareholder diversions of corporate funds." *Id.* at 1300 (noting that the case was appealable to the Ninth Circuit). Having rejected the automatic rules urged by both parties, the Tax Court concluded, in its capacity as the finder of fact, that the diversions at issue in the case were constructive dividends to the extent that the corporation had earnings and profits. See *id.* at 1293, 1300. The IRS subsequently acquiesced in the Tax Court's rejection of the "dominion and control" rule, but reiterated that a diversion of corporate funds cannot qualify as a constructive distribution where "the funds were additional salary or otherwise were received in a nonshareholder capacity." Action on Decision at *2, *Truesdell*, *supra* (AOD 1988-025).

The Second Circuit considers its approach "better reasoned" because, in its view, "plac[ing] greater emphasis on the intent element in criminal tax evasion cases" has the anomalous result of assigning the government "a higher burden of proof in a civil tax collection matter than in a criminal tax evasion prosecution." *D'Agostino*, 145 F.3d at 73. That comparison begins, however, from the faulty assumption that in civil cases, distributions of corporate funds to a shareholder are automatically treated as distributions "with respect to stock." Section 301 applies equally to civil and criminal tax proceedings, and courts have considered the parties' intent when evaluating whether a distribution qualifies as a dividend. See *Elliotts, Inc.*, 716 F.2d at 1244-1245 (the inquiry into whether a payment is compensation or a dividend "may expand into compensatory intent"); cf. *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (a taxpayer "must accept the tax consequences of his choice [of organization of his affairs] whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not"). It is the Second Circuit's approach, not *Miller*, that departs from the ordinary rule in civil tax cases.

c. Although the decision of the court of appeals in *Miller* conflicts with the decision of the Second Circuit in *D'Agostino*, this case is not an appropriate vehicle to resolve the conflict because petitioner cannot prevail under either approach.

The Second Circuit has qualified its "'no earnings and profits, no income' rule" by maintaining that the rule does not apply in cases "of *unlawful* diversion, such as embezzlement, theft, a violation of corporate law, or an attempt to defraud third party creditors."

D'Agostino, 145 F.3d at 73. It repeated that note of caution in *Bok*, explaining that *D'Agostino* had "made clear" that the rule had no application in cases of unlawful diversion. 156 F.3d at 162 n.1 (citing *D'Agostino*, 145 F.3d at 73). That exception has deep roots in the civil tax cases on which the *D'Agostino* court relied. See Pet. App. 14 (Thomas, J., concurring); *Truesdell*, 89 T.C. at 1298 (emphasizing that "petitioner's diversions of income * * * were not per se unlawful" and did not appear to be "stolen, embezzled, or diverted in fraud of creditors"); *DiZenzo* v. *Commissioner*, 348 F.2d 122, 125 (2d Cir. 1965) (emphasizing that "[w]e are not here dealing with sums stolen or embezzled by a taxpayer" and that "[t]here has been no suggestion that the diversions in this case were improper as a matter of corporate law").

In this case, the distribution of corporate funds to petitioner was unlawful for at least three reasons. First, petitioner was not the sole shareholder of HIE; a trust for the benefit of petitioner's son also holds stock in the corporation. Gov't C.A. Br. 5 n.3. Although petitioner introduced minutes from HIE meetings in 1990 and 1991 purporting to grant him broad authority to use corporate funds, an expert witness for the government testified at trial those documents had been falsified. *Id.* at 10. By unilaterally diverting corporate funds to himself and his girlfriend, in excess of his authority, petitioner acted to the detriment of the remaining shareholder and in breach of his fiduciary duties. See *D'Agostino*, 145 F.3d at 73 (indicating that the "no earnings and profits, no income" rule has no application where the diversion of corporate funds was "a violation of corporate law"); *DiZenzo*, 348 F.2d at 125 (same).

Second, petitioner's pleadings in the state-court action suggest that he diverted corporate funds to his girlfriend for the purpose of preventing his wife from obtaining the portion of HIE's assets to which she was entitled in their divorce. Pet. App. 14 (Thomas, J., concurring); see *id.* at 31-32, 34-35. Such diversions "may be properly considered unlawful." *Id.* at 14 (Thomas, J., concurring); see *D'Agostino*, 145 F.3d at 73 (indicating that the "no earnings and profits, no income" rule would not apply where corporate funds were diverted in "an attempt to defraud third party creditors"); *Truesdell*, 89 T.C. at 1298 (same).

Third, the government alleged and proved at the first trial that petitioner had diverted corporate funds in furtherance of a conspiracy to make false statements to a federally insured institution. Petitioner's conviction on that count was affirmed on his first appeal, and it has become final. Pet. App. 61. As Judge Thomas recognized, because the distributions in this case were unlawful, "the outcome would not be affected" even under the Second Circuit's approach. *Id.* at 14 (Thomas, J., concurring); see *id.* at 6 (finding it "by no means certain" that "the facts in this case would implicate the Second Circuit's rule"). This case therefore is not an appropriate vehicle to resolve the conflict.

Petitioner argues (Pet. 15) that the relevant statutes do not admit of any exception for the unlawful diversion of corporate funds. On this view, a shareholder may steal or embezzle corporate funds but still maintain, in a subsequent prosecution for tax evasion, that the diversion was a distribution "to a shareholder with respect to its stock" under Section 301(a). He also argues (Pet. 15-16) that all of his diversions of corporate funds were lawful, and proposes a remand for further factfinding on

that question. No court of appeals has endorsed petitioner's approach, and an inquiry into the lawfulness of the distributions would not address the conflict between the Second and Ninth Circuits. Further review by this Court is unwarranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 06-1509

IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL H. BOULWARE,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR PETITIONER

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I. THE UNCERTAINTY IN DECISIONS OVER THE EFFECT OF STATE COURT JUDGMENTS IN FEDERAL TAX CONTROVERSIES IS SQUARELY PRESENTED.

The government does not dispute that the effect of a state court judgment in a federal tax case is--to use the court of appeals' word--"unclear" under this Court's decisions. App. 40.[1] It argues instead that this case does not present that question. According to the government, the only issue here involves the "scope of the state-court judgment" under Hawaii law. Opp. 10.

The government's argument overlooks what occurred at the retrial. The district court specifically instructed the jury, over Boulware's objection, ER 807-09, that the state court judgment "is not binding on you." App. 25. The government emphasized this point in its rebuttal argument; it told the jury that the state court judgment "doesn't determine anything at all for you, ladies and gentlemen." Tr., Vol. 10, at 200. In upholding the district court's instruction on Boulware's second appeal, the court of appeals declared that it had "rejected Boulware's argument that [the judgment] was controlling on the issue of whether the money held by Lee belonged to HIE and was therefore not taxable to him." App. 11. In light of the district court's jury instruction, the government's rebuttal argument, and the court of appeals' decision, the question of the effect to be given a state court judgment determining property rights--binding, *Aquilino v. United States*, 363 U.S. 509, 512-13 (1960), or merely "proper regard," *Commissioner v. Estate of Bosch*, 387 U.S.

[1] Brief for the United States in Opposition at 9-10 ("Opp.").

456, 464 (1967)--is squarely presented. The Court should grant the writ to resolve that important issue, which has caused enormous confusion in the courts of appeals.

II. THE CONFLICT IN DECISIONS OVER APPLICATION OF THE RETURN OF CAPITAL RULE IN CRIMINAL CASES IS SQUARELY PRESENTED.

The government acknowledges the clear split between the Second and Ninth Circuits on the return of capital defense. Opp. 13. It contends, however, that this case is not an appropriate vehicle to resolve that split "because petitioner cannot prevail under either approach." Opp. 15. This is so, according to the government, because Boulware's receipt of funds from HIE was "unlawful." Opp. 15-18.

The government's argument--which it never raised before the district court or the court of appeals panel--misses the mark. Regardless of whether there is an "unlawful diversion" exception to the return of capital rule, no court or jury, state or federal, has determined that Boulware unlawfully diverted the funds at issue from HIE. The issue has never been litigated.[2] The government's eleventh-hour allegation that the transfers from HIE to Boulware violated the law should not dissuade the Court from resolving the circuit split on an important and recurring issue. The Court should address the "contemporaneous intent" issue that has

[2] The government's reliance on Boulware's conspiracy to make false statements conviction from the first trial is misplaced. Opp. 17. That conviction establishes at most that Boulware conspired to obtain funds unlawfully from a federally insured financial institution through false statements to the institution. It does not establish that Boulware unlawfully diverted funds from HIE, which is the key issue under the exception to the return of capital rule that the government posits.

divided the Second and Ninth Circuits and leave to the lower courts on remand the "unlawful diversion" question.

CONCLUSION

The petition for a writ of certiorari should be granted.

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MISCELLANEOUS

1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed. 2006) 4

REPLY BRIEF FOR PETITIONER

INTRODUCTION

The government concedes that the taxation rules in IRC § 301 apply in civil cases just as in criminal cases. It thus abandons the Ninth Circuit's rationale for the contemporaneous intent requirement. *See* Part I *infra*.

Having disavowed the court of appeals' justification for its intent requirement, the government constructs a *new* requirement--one that Boulware has not had an opportunity to satisfy--from statutory language ("with respect to its stock") that never mentions intent and that no court has ever interpreted to create such a standard. The Court should reject the government's intent requirement and adopt instead the Second Circuit's application of the return of capital rule, which follows the plain language of IRC §§ 301 and 316. *See* Part II *infra*.

The government contends that Boulware cannot invoke the return of capital rule because he "embezzled" the diverted money from HIE. This argument has three flaws. First, IRC §§ 301 and 316 contain no exception for funds that a shareholder embezzles. Second, as the IRS has successfully argued in other cases, a controlling shareholder of a close corporation cannot embezzle from his own company. Finally, if the Court concludes that embezzled funds cannot be a return of capital, then

Boulware must be afforded a jury determination on the embezzlement issue. *See* Part III *infra*.

As a fallback argument, the government asserts that the return of capital rule does not apply because Boulware's diversion of HIE funds was unlawful in other respects. But the statutory language contains no such exception, and the government offers no persuasive reason for the Court to create one. Even if the Court determines that such an exception could apply under some circumstances, Boulware must be permitted to contest the unlawfulness issue before a jury. *See* Part IV *infra*.

ARGUMENT

I. THE GOVERNMENT HAS ABANDONED THE FOUNDATION OF THE NINTH CIRCUIT RULE IT PURPORTS TO DEFEND.

The Ninth Circuit rests the contemporaneous intent requirement on a purported distinction between civil and criminal tax cases. *Miller*, which created the intent requirement, declared that applying the civil return of capital rule in a criminal tax case would "completely ignore[] one essential element of the crime charged: the willful intent to evade taxes, and concentrate[] solely on the issue of the nature of the funds diverted," which "is not the important element." *United States v. Miller*, 545 F.2d 1204, 1214 (9th Cir. 1976). Citing *Miller*, the court below emphasized that "the characterization of diverted corporate funds for civil tax purposes does

not dictate their characterization for purposes of a criminal tax evasion charge." Pet. App. 5. And the court rejected Boulware's reliance on *Truesdell v. Commissioner*, 89 T.C. 1280 (1987), because "*Truesdell* was a civil proceeding and thus inapposite given *Miller's* explicit holding that civil classifications of diverted corporate funds do not control in criminal cases." Pet. App. 5.

Boulware demonstrated in his opening brief that the Ninth Circuit approach improperly disregards the tax deficiency element of tax evasion and creates an unwarranted disparity between tax rules in civil and criminal cases. *See* Brief for Petitioner 15-26 ("Pet. Br."). The government now acknowledges--directly contrary to the Ninth Circuit's position in this case and in *Miller*--that the return of capital rule applies in criminal tax cases exactly as it does in civil tax cases. Brief for the United States 12, 19 n.4, 24 ("Gov't Br.").

Having correctly abandoned the Ninth Circuit's rationale for the contemporaneous intent requirement, the government develops a new theory, based on the phrase "with respect to its stock" in IRC § 301(a).[1] As discussed in the next part, however, that phrase has a settled meaning that does not turn upon the intent of the corporation or the shareholder. Neither the statutory text nor the

[1] The government, which rests its case in this Court on that single phrase, never relied on it in the district court or before the court of appeals panel. It began developing the argument it advances now in its opposition to Boulware's petition for rehearing en banc. Neither in *Miller* nor in this case did the court of appeals place any weight on the phrase the government now finds decisive.

cases construing that language support the government's position.

II. THE PHRASE "WITH RESPECT TO ITS STOCK" MERELY REQUIRES THAT A DISTRIBUTION BY A CORPORATION TO A SHAREHOLDER BE MADE WITHOUT CONSIDERATION OR EXPECTATION OF REPAYMENT.

A. As Boulware noted in his opening brief (Pet. Br. 27-28), courts consider a distribution to a shareholder to be "with respect to [the corporation's] stock" if the corporation confers a benefit on the shareholder without expectation of repayment and without receiving equal value.[2] "[T]he phrase 'distributes . . . with respect to . . . stock' is a term of art with a consistent meaning throughout the Code. It is used only to refer to distributions without consideration, not to sales for a cash consideration." *Commissioner v. Baan*, 382 F.2d 485, 493 (9th Cir. 1967), *aff'd on other grounds sub nom. Commissioner v. Gordon*, 391 U.S. 83 (1968). This settled interpretation of "with respect to its stock" does not rest upon the intent of the corporation or the shareholder.

The government ignores the cases construing the "with respect to its stock" language. It purports to find in that phrase something that no court has ever found there: a requirement that the share-

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[2] *See, e.g., Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 221, 231-32 (3d Cir. 2002); 1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 8.05[1], at 8-39 (7th ed. 2006).

holder or the corporation *intend* that the distribution be with respect to the corporation's stock or *intend* that it be to the shareholder in his capacity as such. Gov't Br. 11, 18, 23-24, 33.

The text of IRC § 301 does not support the government's proposed interpretation. The statute does not mention intent. The government acknowledges that the "plain meaning" of the "with respect to its stock" phrase "limits the applicability of Section 301's tax treatment to distributions that are made to shareholders *qua* shareholders, *i.e., by reason of* the recipients' status as shareholders"--a formulation that does not involve intent. Gov't Br. 15. Turning to dictionaries, the government finds "with respect to" defined as "with reference to," "as regards," "insofar as concerns," "referring to," "concerning," "regarding," and "as to." *Id.* at 16 & n.3. None of these definitions involves intent. Nor does the IRS interpretive regulation, 26 C.F.R. § 1.301-1(c), or the legislative history of IRC § 301. *See* Gov't Br. 16.

Summarizing the definitions on which it relies, the government concludes: "Applying those ordinary meanings [of 'with respect to'] here, the plain text of Section 301(a) requires that the distribution of property by the corporation be made to a shareholder because of his ownership of its stock." Gov't Br. 16; *see id.* at 21 (requiring evidence of a "causal link" between the distribution and stock ownership). But a *causal* relation does not necessarily require intent. A rock rolls down a hill *because of* gravity, but that causal relation does not

require intent. A person slips *because* the sidewalk is icy, but that causal relation does not require intent. And a controlling shareholder such as Boulware receives corporate distributions *because* he owns stock, but that causal relation does not require that the shareholder or the corporation have any particular intent with respect to the distribution.

The "causal link" that the government finds in the statutory phrase "with respect to its stock" squares easily with the interpretation courts have uniformly given that phrase--a "distribution[] without consideration." *Baan*, 382 F.2d at 493. When a corporation distributes funds to a shareholder without consideration--without, for example, receiving services in return--it does so *because of* the shareholder's status as shareholder. But that "causal link" does not require that either the corporation or the shareholder have any particular intent. Because the contemporaneous intent requirement has no basis in the "with respect to its stock" phrase or any other part of the statutory text, the Court should reject it. *See, e.g., Jama v. Immigration and Customs Enforcement*, 543 U.S. 335, 341 (2005) ("We do not lightly assume that Congress has omitted from its adopted text requirements that it nonetheless intends to apply . . . .").

B. The government insists that "the approach of the court below is consistent with civil tax cases." Gov't Br. 24-31. But the government does not cite a single civil tax case interpreting the "with respect to its stock" phrase to require contemporaneous intent by the shareholder or the corpor-

ation. Most important, the Tax Court in *Truesdell*--which settled the application of the return of capital rule in civil cases--did not read that phrase to create such a requirement.

The government cites cases holding that intent may be relevant when a shareholder or the IRS contends that the shareholder received corporate funds as an employee or a creditor. It argues that "[p]etitioner offers no explanation why intent should be relevant to determining whether a payment was made by reason of a nonshareholder capacity, but not by reason of a shareholder capacity" and characterizes the two circumstances as "opposite sides of the same coin." *Id.* at 19.

Intent plays a different role in these circumstances for obvious reasons. The nonshareholder relationships that IRC § 301(a) excludes from the taxation rules in § 301(c)--employer/employee and lender/borrower, for example--generally depend for their formation on the intent of the parties. *See, e.g., Crowley v. Commisioner*, 962 F.2d 1077, 1079 (1st Cir. 1992) (loan); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1244-48 (9th Cir. 1983) (employee). Thus, courts routinely look to the parties' intent to determine if one of these relationships exists.

By contrast, the shareholder relationship arises automatically from the purchase of shares, without any particular intent by the stock purchaser or the corporation. When the shareholder controls the corporation, as Boulware did HIE, money he obtains from it without providing equivalent value in return is a "distribution . . . with respect to [the

corporation's] stock," even though "neither the corporation nor the shareholder intended a dividend." *Mignon v. Commissioner*, 73 T.C. 980, 993-94 (1980). This--and not the government's novel position--is the "ordinary rule in civil tax cases." Gov't Br. 28; *see, e.g., Dynamics Corp. of America v. United States*, 392 F.2d 241, 247 (Ct. Cl. 1968); *Noble v. Commissioner*, 368 F.2d 439, 443 (9th Cir. 1966); *Lengsfield v. Commissioner*, 241 F.2d 508, 511 (5th Cir. 1957); *Emmerson v. Commissioner*, 44 T.C. 86, 90-91 (1965); *Barbourville Brick Co. v. Commissioner*, 37 T.C. 7, 13 (1961).[3]

C. The government argues that the Court should graft a contemporaneous intent requirement onto the return of capital rule to avoid encouraging tax fraud. Gov't Br. 12, 22-24. The statutory language suffices to dispose of this policy argument. Even if the government were correct about the effect of the Second Circuit's position, the Court could not add an intent requirement to the plain language of

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[3] The government suggests that the absence of distributions to HIE's other shareholder precludes treating the distributions as "with respect to its stock" and thus subject to IRC § 301(c). Gov't Br. 35 n.12. But the government cites no authority for this proposition, and the law is to the contrary. In *Federbush v. Commissioner*, 34 T.C. 740 (1960), *aff'd*, 325 F.2d 1 (2d Cir. 1963) (per curiam), for example, the Tax Court declared that "[a] distribution of corporate earnings may constitute a dividend even though the formalities of a dividend declaration are not observed, even though the distribution is not recorded on the corporate books as such, even though it is not in proportion to the stockholdings, and even though some of the stockholders do not participate in its benefits." 34 T.C. at 750; *see, e.g., Sachs v. Commissioner*, 277 F.2d 879, 882 (8th Cir. 1960); *Simon v. Commissioner*, 248 F.2d 869, 875 (8th Cir. 1957); *Paramount-Richards Theatres, Inc. v. Commissioner*, 153 F.2d 602, 604 (5th Cir. 1946).

IRC §§ 301 and 316. *See, e.g., Artuz v. Bennett*, 531 U.S. 4, 10 (2000) ("Whatever merits these and other policy arguments may have, it is not the province of this Court to rewrite the statute to accommodate them."); *Brogan v. United States*, 522 U.S. 398, 408 (1998) ("Courts may not create their own limitations on legislation, no matter how alluring the policy arguments for doing so . . . ."); *North Haven Board of Education v. Bell*, 456 U.S. 512, 535 n. 26 (1982) ("These policy considerations were for Congress to weigh, and we are not free to ignore the language and history of [the statute] even were we to disagree with the legislative choice.").

But the premise of the government's argument is wrong in any event, for two key reasons. First, a return of capital subject to IRC § 301(c)(2) provides no taxable gain to the shareholder. The shareholder merely receives back the money that he invested in the corporation, diminishing the value of his shares in the process. The return of the shareholder's investment, with the accompanying diminution in value of his shares, produces no income to the shareholder.

Second, under the plain terms of IRC § 301(c), the shareholder can never claim a return of capital that exceeds his total basis in the stock. A shareholder with a five dollar basis can never claim more than a five dollar return of capital (and then only if the corporation lacks earnings and profits). That is because each return of capital is "applied against and reduce[s] the adjusted basis of the stock." IRC § 301(c)(2). Thus, there is no possibility that a

shareholder can obtain (for example) ten dollars of nontaxable return of capital on five dollars of basis.

These points refute the government's "invitation to tax fraud" argument. It is *always* the case, with or without the return of capital rule, that a taxpayer who conceals money does not have to pay taxes on it unless he gets caught. But the return of capital rule does not *increase* a taxpayer's incentive to conceal money. Whether or not a shareholder conceals diverted funds from the IRS, and whether or not the IRS discovers those concealed funds, the shareholder can never claim more than the amount of his basis--the amount he has put into the corporation--as a return of capital.

The government offers a second policy argument. Echoing *Miller*, it declares that applying the return of capital rule as written "would create an anomaly." Gov't Br. 23. According to *Miller*, "[a] taxpayer who diverted funds from his close corporation when it was in the midst of financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in the stock) for failure to report such sums as income; while that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." 545 F.2d at 1214 (quoted at Gov't Br. 23). The government implies that the contemporaneous intent requirement is necessary to cure this "anomaly."

But this is not an anomaly; it is the difference between a defendant who violates the tax evasion statute and one who does not. The government

cannot prove the "tax deficiency" element of tax evasion against the defendant whose corporation has no earnings and profits. It *can* prove that element against the defendant whose corporation *does* have earnings and profits and who thus cannot present a return of capital defense. The first defendant is guilty; the second is not. Simply put, "The diversion of the funds cannot constitute a criminal offense, despite criminal intent, if no taxes are due." *United States v. D'Agostino*, 145 F.3d 69, 73 (2d Cir. 1998); *see* Pet. Br. 20-21.

D. The government's proposed intent standard not only lacks any textual basis, case support, or coherent policy rationale; it also differs markedly from the standard that the district court and the court of appeals insisted Boulware meet. The district court declared that "if the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions were intended to be *a return of capital*." JA 91 (emphasis added). Affirming, the court of appeals likewise held, in accordance with *Miller*, that in criminal tax cases the defendant must show that the corporate distribution was "intended to be *a return of capital*." Pet. App. 4 (emphasis added). The question on which this Court granted certiorari, drawn verbatim from the government's opposition, is whether the return of capital rule automatically applies to a shareholder's diversion of corporate funds (assuming the earnings and profits and basis predicates are met), "even if the diversion was not intended as a *return of capital*." *Boulware v. United States*, 128 S. Ct. 32 (2007) (emphasis added).

An intent that a diversion be a "return of capital" is different than an intent that a diversion be a "distribution with respect to [the corporation's] stock" (Gov't Br. 33) or a "distribution to the shareholder in his capacity as such" (Gov't Br. 18). Boulware has acknowledged that he cannot establish a contemporaneous intent to treat the money he received from HIE as a "return of capital." By contrast, Boulware has never had an opportunity to show his understanding that he obtained the diverted funds because of his ownership of HIE's stock and in his capacity as an HIE shareholder (and not, for example, as compensation for his services as HIE's president). If the Court adopts the government's proposed standard, Boulware should receive a new trial at which he can produce evidence satisfying the new requirement.

The government appears uncertain whether a showing of contemporaneous intent is *required* for a defendant to invoke the return of capital rule.[4] At several points, the government casts intent merely as one of many "facts and circumstances" that a factfinder considers in resolving the "with respect to its stock" issue. The government contends, for example, that "[w]hether a corporate payment meets [the 'with respect to its stock'] requirement turns on

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[4] The government equivocates as well on whether the taxpayer, the corporation, or both must possess the requisite intent (however defined). *See* Gov't Br. 12 (referring to "the intent of the corporation and the parties"); *id.* (referring to "the purported intent of the corporation or shareholder"); *id.* at 18 ("'taxpayer and/or the corporation'" (quoting *Miller*, 545 F.2d at 1215)), 24 ("intent of the corporation and the shareholder"), 29 ("intent of the corporations and employees"), 30 ("intent of the corporation and the taxpayer").

all the facts and circumstances of the case." Gov't Br. 11. Those "facts and circumstances" include, according to the government, "the intent of the corporation and the parties." *Id.* at 12; *see id.* at 24, 30.

If the government's "facts and circumstances" formulation is correct, then the district court and the court of appeals erred in holding that the intent showing is a threshold requirement the defendant *must* satisfy to invoke the return of capital rule, rather than merely a "fact or circumstance" to be considered along with many others. Here too, if the Court adopts the government's standard, Boulware should receive a new trial at which he has an opportunity to satisfy it.

III. THE GOVERNMENT'S EMBEZZLEMENT THEORY DOES NOT WARRANT AFFIRMANCE.

The government insists that Boulware embezzled the funds he obtained from HIE and that embezzled funds cannot be a return of capital. *E.g.*, Gov't Br. 18, 21, 36-37. This argument fails for three reasons.

First, nothing in the text of IRC §§ 301 and 316 supports a general exclusion of embezzled or stolen funds from the taxation rules of § 301(c). Some shareholder thefts will undoubtedly occur under circumstances that do not fall within the statutory terms. Boulware offered an example in his opening brief (Pet. Br. 33): if a burglar who happens to own a few General Motors shares breaks into the

company's headquarters and steals the petty cash, that will not be a "distribution" by the corporation to the shareholder "with respect to its stock." But when a controlling shareholder such as Boulware diverts funds from a close corporation, the taxation rules in IRC § 301(c) apply according to their plain language, regardless of whether the transaction could be characterized under state law as an offense against the corporation.[5]

Second, in a series of cases the IRS has successfully--and correctly--argued that the controlling shareholder of a close corporation cannot embezzle from his own corporation. *See, e.g., Stark v. Commissioner*, T.C. Memo 1999-1, 1999 Tax Ct. Memo LEXIS 2, at *12-*13; *Frankland Racing Equipment, Inc. v. Commissioner*, T.C. Memo 1987-210, 1987 Tax Ct. Memo LEXIS 206, at *69; *M.J. Laputka and Sons, Inc. v. Commissioner*, T.C. Memo 1981-730, 1981 Tax Ct. Memo LEXIS 10, at *30; *Federbush v. Commissioner*, 34 T.C. 740, 750-51 (1960), *aff'd*, 325 F.2d 1 (2d Cir. 1963) (per curiam).

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[5] Boulware indisputably controlled HIE. *See, e.g., In re Cysive, Inc. Shareholders Litigation*, 836 A.2d 531, 552-53 (Del. Ch. 2003). He founded the company, owned fifty percent of the stock, and served as chairman and president. The other fifty percent of the stock was held by a trust that Boulware created for his son, with the boy's mother (Boulware's girlfriend, Jin Sook Lee) as trustee. JA 68, 74, 82-83, 86-88, 133. In closing argument the government acknowledged that HIE was Boulware's corporation; it declared: "And that's what this case is all about: The money this defendant stole, or embezzled if you like that word better, from his own corporation." ER 815; *see, e.g.*, ER 817 ("his corporation"), 818 (arguing that Boulware "took millions of dollars from his company and put it in his pocket and spent it, in large part, on his first wife and his girlfriend, with no tax consequences to him"), 819 ("his company"), 820 ("his corporation").

In each of these cases, the corporate taxpayer claimed a deduction for a theft loss under IRC § 165 based on a controlling shareholder's diversion of funds from the corporation. The IRS argued successfully that a controlling shareholder necessarily lacks the intent to embezzle from his own corporation.

In *Stark*, for example, the Tax Court found it "well established that a diversion of corporate funds by shareholders with complete, or near complete, control of the corporation does not entitle the corporation to a theft loss deduction, regardless of how embezzlement is defined under local law. . . . In such a situation, the shareholders have the implied consent of the corporation and take the funds under a claim of right." 1999 Tax Ct. Memo LEXIS 2, at *12-*13; *see, e.g., Drybrough v. Commissioner*, 238 F.2d 735, 738 (6th Cir. 1956) (same).

In *Frankland Racing Equipment*, the IRS argued that "no embezzlement occurred where a dominate [sic] shareholder misappropriates corporate monies as the requisite intent to embezzle is absent." 1987 Tax Ct. Memo LEXIS 206, at *69. The Tax Court agreed. It found that Frankland (the controlling shareholder) "had no intent to embezzle from Frankland Racing as his objective was to conceal the financial performance of the corporation from [his wife] and to evade tax. The funds diverted pursuant to the scheme are accurately classified as constructive dividends." *Id.*; *see Federbush*, 325 F.2d at 2 (no embezzlement by controlling shareholders

where "[t]he sole controlling purpose of the diversion was evasion of income taxes").

In *M.J. Laputka and Sons*, the Tax Court agreed with the IRS' argument that "inasmuch as the shareholders who misappropriated the money also dominated the corporation, it would be anomalous to say that there was the requisite intent to embezzle. They would be taking money from themselves, and this does not constitute embezzlement." 1981 Tax Ct. Memo LEXIS 10, at *30. The court concluded: "The money diverted by [the controlling shareholders] and used by them for their personal benefit is more accurately described as disguised dividends to them." *Id.* at *31.

These cases and others like them confirm, in keeping with the longstanding position of the IRS, that corporate diversions by controlling shareholders cannot be considered embezzlement and must instead be taxed in accordance with IRC § 301(c).

Third, if the Court concludes that funds a controlling shareholder embezzles from his own corporation do not fall within IRC § 301(c), then Boulware should receive a jury determination on the elements of embezzlement. The government concedes that the jury was not "expressly instructed" on embezzlement or any other theory of unlawfulness. Gov't Br. 37. But the government cites a portion of the closing argument in which the prosecutor claimed that Boulware embezzled or stole the diverted funds from HIE and insists that the jury "necessarily . . . accepted the government's theory of the case." *Id.* (citing ER 815-20).

The government is wrong. Nothing in the district court's instructions required the jury to make any finding that Boulware had embezzled from HIE. *See* ER 845-63 (jury instructions). The jury could have found Boulware guilty of tax evasion and tax perjury without coming to any conclusion about whether he had otherwise acted unlawfully.

The government argued the opposite of its current position in Boulware's first appeal. On that appeal, Boulware contended that the evidence was insufficient because the government had failed to prove that he embezzled or stole the diverted funds from HIE. He argued as well that the government's embezzlement claim had constructively amended the indictment, which did not allege that offense. Appellant Boulware's Corrected Opening Brief at 20-35, Nos. 02-10287, 02-10338 (9th Cir.) (available on Westlaw at 2003 WL 22706800).

The government countered these arguments in terms that refute its position here. It declared that "[n]either in the indictment nor during its presentation of evidence did the government attempt to place any label on the funds diverted by defendant, other than 'income.' . . . Depending on the circumstances, the diverted funds could have constituted, *inter alia*, embezzled or stolen funds, dividends, commissions, or some form of bonus or salary." Brief for the Appellee/Cross-Appellant at 16, Nos. 02-10287, 02-10338 (9th Cir.) (available on Westlaw at 2003 WL 22706655). The government observed that the district court had instructed the jury that attorneys' arguments are not evidence. *Id.*

at 17. It noted that the court's instructions "did not include, as an essential element, that defendant obtained the funds by theft from HIE." *Id.* It concluded that "[n]either the charges in the indictment nor the government's theory of the case depended on the violation of Hawaii state law concerning theft, and accordingly the indictment did not need to allege, nor did the government have to prove, a violation of state law." *Id.* at 18-19; *see id.* at 21 ("The language of the indictment did not require the government to prove that defendant stole money from HIE in violation of Hawaii law. . . . Thus, proof of the tax charges did not require the Government to establish that defendant obtained the unreported income through theft.").

The Ninth Circuit accepted the government's argument. It agreed that the government "could have proved the elements of §§ 7206(1) and 7201 beyond a reasonable doubt without proving . . . that Boulware stole the funds from HIE . . . ." Pet. App. 54.

The government's arguments to the court of appeals on Boulware's first appeal apply equally here. In Boulware's second trial, as in his first, the government argued in closing that Boulware embezzled or stole the diverted funds from HIE. ER 815-20. In Boulware's second trial, as in his first, the indictment did not allege theft or embezzlement, and the instructions did not require the jury to find those offenses in convicting Boulware. ER 23-34 (indictment), 845-63 (instructions). In Boulware's second trial, as in his first, the district court

instructed the jury that the attorneys' arguments are not evidence. ER 855. It is wrong, therefore, to contend, as the government does, that the jury necessarily found that Boulware embezzled the diverted funds from HIE. Because there has been no such finding, the Sixth Amendment precludes application on appeal of an embezzlement exception to the return of capital rule.

IV. SECTION 301 APPLIES TO UNLAWFUL DIVERSIONS.

The government argues in the alternative that the taxation principles in IRC § 301(c) do not apply to "unlawful" shareholder diversions of corporate assets. Apart from Boulware's alleged embezzlement from HIE--discussed above--the government asserts that Boulware acted unlawfully toward the other HIE shareholder (a trust that he established in favor of his young son, with the boy's mother, Jin Sook Lee, as trustee) and that he diverted corporate funds to Jin Sook Lee to defraud his wife. Gov't Br. 35-36.

The government has no textual basis for such an exception to the return of capital rule. It cites no case that has applied such an exception to defeat a return of capital claim; the language it quotes from *D'Agostino*, *Truesdell*, and other cases is dictum. The government has not found a word of legislative history to support the exception. And it offers no policy justification for permitting the tax treatment of a corporate distribution to a shareholder to turn on whether the transaction amounts to an actionable wrong against a third party. Such an exception to

IRC § 301(c) would introduce a substantial element of uncertainty into the tax system with no corresponding benefit.

The government purports to distinguish *Drybrough* on the basis that the court "rejected the claim that the defendants had embezzled the funds." Gov't Br. 36 n.13. That is true, but it misses the point in this context.[6] *Drybrough* is important here because in that case the holders of 80 percent of the stock of a close corporation diverted corporate funds to themselves. The wife of one of the shareholders--who held 20 percent of the stock--did not know about the diverted funds. *See* 238 F.2d at 738. In holding that the predecessor provisions to IRC §§ 301 and 316 controlled the taxation of the diverted funds, the court of appeals never suggested that the controlling shareholders' possible breach of their fiduciary duty to the minority shareholder removed the distributions from the taxation rules that now appear in IRC § 301(c). *See id.*; *see also Frankland Racing Equipment*, 1987 Tax Ct. Memo LEXIS 206, at *7, *18-*19, *24, *52, *69 (controlling shareholder's diversion of corporate assets taxed as constructive dividends where intent was in part to "conceal the financial performance of the Corporation from [his wife]," who was a minority shareholder and from whom he was getting a divorce).

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[6] The portion of *Drybrough* on which the government relies squarely supports Boulware's argument in Part III that as a controlling shareholder he could not embezzle from HIE. The *Drybrough* court declared, in terms directly applicable here, that the controlling shareholders "took the corporation's funds under a claim of right and with the implied consent of the corporation" and thus did not embezzle. 238 F.2d at 738.

Even if the Court were to adopt the government's proposed exception to the plain language of IRC §§ 301 and 316, that would not change the outcome here. The government tacitly concedes that in the district court it "did not allege or prove that [Boulware's] diversions of corporate funds were unlawful" in either of the respects it now identifies. *D'Agostino*, 145 F.3d at 73. Nor did the government contest the lawfulness of the HIE diversions to Boulware before the Ninth Circuit panel. Judge Thomas raised that issue for the first time in his concurrence. Pet. App. 14. If an element of the offenses with which Boulware is charged turns on whether the HIE distributions defrauded his son's trust or his former wife, the Sixth Amendment guarantees him the opportunity to contest that issue before the jury.[7]

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[7] Although the matter must be decided by a jury if the Court finds it relevant, we note that the state court pleadings to which the government cites do not support its claim that Boulware diverted funds to Jin Sook Lee "for the purpose of preventing his wife from obtaining the portion of the corporation's assets to which she was entitled in their divorce." Gov't Br. 35. To the contrary, Boulware contended in the state court action--and the state court judge and jury agreed--that he transferred the funds to Jin Sook Lee to hold on behalf of HIE so that the corporation could buy out Boulware's wife's interest. *See, e.g.*, Pet. App. 31-36; JA 73-80, 83-85. The record reflects that the money was transferred to Lee not to defraud Boulware's wife, but to ensure that HIE could pay her for her interest in the company.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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No. 06-1509

IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL H. BOULWARE,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a non-taxable return of capital up to the shareholder's stock basis, *see* 26 U.S.C. § 301(c)(2), even if the diversion was not intended as a return of capital.

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BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-14) is reported at 470 F.3d 931.[1] The court of appeals' order denying Boulware's petition for rehearing (Pet. App. 63) is unreported. The district court's oral rulings (JA 50-56, 90-92, 137-38) are unreported. The court of appeals' ruling on Boulware's first appeal (Pet. App. 27-62) is reported at 384 F.3d 794.

JURISDICTION

The court of appeals entered judgment on December 13, 2006. Pet. App. 1. The court denied a timely petition for rehearing on April 23, 2007. Pet. App. 63. Petitioner invoked the jurisdiction of this Court under 28 U.S.C. § 1254(1) by filing a petition for writ of certiorari on May 11, 2007. This Court granted the petition on September 25, 2007.

STATUTORY PROVISIONS INVOLVED

Section 301 of the Internal Revenue Code (Title 26, United States Code) provides in relevant part:

> (a) In general. Except as otherwise provided in this chapter, a distribution

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[1] The Appendix to the petition for a writ of certiorari is cited as "Pet. App." The Joint Appendix is cited as "JA." The Excerpts of Record from the court of appeals are cited as "ER."

of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . . .

(c) Amount taxable. In the case of a distribution to which subsection (a) applies--

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.

(A) In general. . . . [T]hat portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

. . . .

Section 316 of the Internal Revenue Code provides in relevant part:

> (a) General rule. For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders--
>
> (1) out of its earnings and profits accumulated after February 28, 1913, or
>
> (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

STATEMENT OF THE CASE

Petitioner Michael Boulware founded Hawaiian Isles Enterprises ("HIE") in the 1980s and served as chairman and president of the company. HIE and its subsidiaries sell coffee, bottled water, and other products, primarily in Hawaii. At all relevant times, Boulware owned at least half of the HIE stock. JA 68, 74, 82-83, 86-88, 133.

In 2001, the government obtained an indictment against Boulware, charging him with tax evasion and tax perjury. *See* IRC §§ 7201, 7206(1).[2] The tax counts alleged that Boulware failed to report as income approximately $10 million that he allegedly diverted from HIE. JA 10-18.

The government contended that Boulware diverted the money from HIE in several ways. First, it asserted that between 1989 and 1993, HIE sold coffee to two companies--Pele Trading and Hawaiian Kona Coffee--and that Boulware directed those companies to make payments totaling $2.6 million to him or to his girlfriend, Jin Sook Lee. *E.g.*, ER 307-12, 333-41, 460-61, 1010. Second, the government claimed that over a three-year period, Boulware obtained $3.6 million that HIE received from direct sales of tobacco and coffee products at its warehouse. ER 463-67. Third, the government alleged that in 1992, Boulware converted for his own use $638,000

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[2] All citations to the Internal Revenue Code ("IRC") are to Title 26 of the United States Code. The original indictment also charged Boulware with making false statements to a federally insured financial institution and conspiracy to make false statements. Those charges are not at issue here.

loaned to HIE by a financial institution. ER 343-66. Fourth, the government contended that Boulware caused HIE to pay for work on the house where Jin Sook Lee lived. ER 396-401. Fifth, the government asserted that in 1994 Boulware obtained $295,000 from HIE through Bonded Construction and a company Boulware owned named Automated Equipment. ER 315-23, 404-09, 1010. Sixth, from 1993 through 1995, Automated Equipment received $1.2 million from HIE for what the government claimed were phony lease arrangements. ER 467-69, 1010. Finally, the government alleged that from 1995 through 1997, Boulware obtained a substantial amount of money from HIE through two Hong Kong companies--Harvest International Coffee King and Forest Trading--and a Tonga company. *E.g.*, ER 327-30, 375-93, 412-17, 472-79, 1010. *See generally* ER 495-520 (summarizing transactions).

Following a guilty verdict, a panel of the Ninth Circuit reversed Boulware's conviction. The court held that the district court erred in excluding evidence of a state court judgment in an action brought by Jin Sook Lee against Boulware and HIE concerning ownership of funds transferred to her. *United States v. Boulware*, 384 F.3d 794 (9th Cir. 2004) (reprinted at Pet. App. 33-52), *cert. denied*, 546 U.S. 814 (2005).

At the retrial, Boulware sought to negate the "tax deficiency" and false statement elements of the tax evasion and tax perjury charges by presenting evidence that the money he received from HIE constituted nontaxable returns of capital he had

invested in the company. JA 58-66, 97-98. He also sought a return of capital jury instruction. JA 26-30.

The government moved to exclude the return of capital evidence. JA 19. Citing *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976), the government argued that before the return of capital rules apply in a criminal tax case, "'there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be [a return of capital].' . . . Where, however, no such foundation is laid, the constructive distribution rules are irrelevant to the issues in criminal tax prosecutions and do not apply." JA 21-22 (quoting *Miller*, 545 F.2d at 1215). The government also opposed Boulware's proposed return of capital jury instruction. It again noted the requirement under *Miller* that Boulware establish a contemporaneous intent to treat the diverted funds as a return of capital. JA 36, 39-40. The government explained "[t]he rational[e] behind such a rule" as follows: "Tax evaders should not escape criminal liability simply because the intricacies of the tax law result in no tax due and owing." JA 40.

The district court agreed with the government. Relying on *Miller*, the court concluded that, to obtain admission of the return of capital evidence, Boulware "must not show merely that the funds could have been a return of capital; he must introduce evidence showing that, at the time of the transfer, the funds were in fact a return of capital." JA 138; *see* JA 91 ("Thus, if the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions

were intended to be a return of capital."). Because Boulware could not make this showing, the court precluded his evidence and refused to give a return of capital jury instruction. *E.g.*, JA 50-56, 90-92, 137-38.

The jury found Boulware guilty. The district court sentenced him to 60 months incarceration. JA 178. He appealed. JA 188.

On December 13, 2006, the court of appeals affirmed Boulware's conviction and sentence. Because Boulware's proffered evidence in support of his return of capital defense did not satisfy the *Miller* contemporaneous intent requirement, the court concluded that the district court did not err in excluding that evidence and in refusing to instruct on the defense. Pet. App. 3-6. The court recognized that under *Miller* the return of capital rule applies differently in criminal cases than in civil cases. It also acknowledged that its approach conflicts with decisions from the Second Circuit. Pet. App. 5-6. Concurring, Judge Thomas observed that if the panel were "writing on a clean slate, rather than under the controlling precedent of [*Miller*], I would adopt the approach of the Second Circuit concerning the return to capital defense." Pet. App. 13.

The court of appeals denied Boulware's petition for rehearing en banc on April 23, 2007. Pet. App. 63. This Court granted Boulware's timely petition for writ of certiorari on September 25, 2007.

SUMMARY OF ARGUMENT

The return of capital rule arises from the interplay of IRC §§ 301 and 316. Section 316(a) defines "dividend" as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits . . . ." Section 301(c)(1) provides that dividends are taxed as ordinary income. Section 301(c)(2) provides that distributions that do not constitute dividends shall be applied against and reduce the shareholder's basis in his stock. Such returns of the shareholder's investment in his stock are not income and thus are nontaxable. Finally, IRC § 301(c)(3) provides that nondividend distributions that exceed the shareholder's basis are taxed as capital gains.

The Ninth Circuit has added an additional hurdle for criminal defendants seeking to invoke the return of capital rule in IRC § 301(c)(2). The defendant must not only produce evidence that the corporation lacked earnings and profits and the distribution did not exceed his basis in the stock; he must *also* provide a "demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return [of capital]." *Miller*, 545 F.2d at 1215; *see* Pet. App. 4.

The *Miller* contemporaneous intent requirement has no basis in the statutory text and creates an unwarranted disparity between civil and criminal tax liability. *Miller* also improperly reduces the government's burden of proof on the tax deficiency element of tax evasion under IRC § 7201. *See, e.g., United States v. Bok*, 156 F.3d 157 (2d Cir. 1998);

United States v. D'Agostino, 145 F.3d 69 (2d Cir. 1998).

The government offers two defenses of the result in this case. First, it contends that the phrase "with respect to its stock" in IRC § 301(a) supports the *Miller* contemporaneous intent requirement. But that phrase merely differentiates between corporate distributions unrelated to the shareholder's status as such--salary and loans, for example--and all other distributions to shareholders, including constructive dividends and returns of capital. The phrase does not require that the shareholder or the corporation manifest any particular intent before a distribution is considered to be "with respect to [the corporation's] stock" and thus subject to IRC § 301(c).

Second, the government argues that *unlawful* corporate distributions to a shareholder are excluded from the provisions of IRC §§ 301 and 316 and thus must be taxed as ordinary income regardless of the corporation's earnings and profits. The language of §§ 301 and 316 provides no support for such an exception to the ordinary rules governing corporate distributions. Although an unlawful distribution to a shareholder may have civil and criminal consequences to the corporation and the shareholder, the unlawfulness does not change the taxation of the distribution.

Even if the Court determines that the unlawful character of a distribution removes it from the provisions of IRC §§ 301 and 316, that does not affect the result here. No jury (or court, for that

matter) has found that the diversions from HIE to Boulware violated any law. An appellate finding of unlawfulness would violate Boulware's Fifth and Sixth Amendment right to have a jury decide all facts essential to a verdict of guilt beyond a reasonable doubt. Thus, if the Court determines that unlawful distributions do not fall within IRC §§ 301 and 316, it should reverse Boulware's conviction and remand for a new trial. At a retrial of this case, the government would have an opportunity to prove to a jury beyond a reasonable doubt that the distributions from HIE to Boulware were unlawful.

ARGUMENT

I. SECTIONS 301 AND 316 OF THE INTERNAL REVENUE CODE GOVERN THE TAXATION OF CORPORATE DIVERSIONS.

Two statutes--IRC §§ 301 and 316--govern the taxation of money that a taxpayer diverts from a corporation in which he owns stock. IRC § 301(c)(1) provides that "dividends" are taxed as ordinary income.[3] IRC § 316(a) defines "dividend" as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits . . . ." IRC § 316 adds that, with exceptions not applicable here, "every distribution is made out of earnings and profits to the extent thereof, and from the most

[3] IRC § 301(c) applies "in the case of a distribution to which subsection (a) applies." IRC § 301(a), in turn, applies to distributions "made by a corporation to a shareholder with respect to its stock." We discuss the phrase "with respect to its stock" in Part II(B) below.

recently accumulated earnings and profits." IRC § 301(c)(2) provides that "[t]hat portion of the distribution which is not a dividend"--that is, the portion of the distribution that is not "out of earnings and profits"--shall be "applied against and reduce the adjusted basis of the stock." Such returns of the shareholder's investment in his stock are not income and thus are nontaxable. Under IRC § 301(c)(3), nondividend distributions that exceed the shareholder's basis are taxed as capital gains.

In combination, these statutes produce the return of capital rule at issue in this case: When a corporation without earnings or profits distributes funds to a shareholder, the distribution is a nontaxable return of capital, up to the shareholder's basis in his stock. Courts have repeatedly applied this principle to a taxpayer's diversion of money from a corporation in which he owns stock.

The return of capital rule applies to shareholder diversions of corporate funds even where the corporation does not formally label the distribution as a dividend. Courts characterize such diversions as "constructive dividends" and apply the taxation principles in IRC §§ 301(c) and 316. *See, e.g., United States v. Bok*, 156 F.3d 157, 162 (2d Cir. 1998); *United States v. D'Agostino*, 145 F.3d 69, 72-73 (2d Cir. 1998); *Noble v. Commissioner*, 368 F.2d 439, 442-43 (9th Cir. 1966); *DiZenzo v. United States*, 348 F.2d 122, 125-27 (2d Cir. 1965).

Since the watershed decision in *Truesdell v. Commissioner*, 89 T.C. 1280 (1987), the United States Tax Court has consistently applied IRC

§§ 301(c) and 316 to shareholder diversions. *See, e.g., AJF Transportation Consultants v. Commissioner*, 77 T.C.M. (CCH) 1244 (1999); *DiLeo v. Commissioner*, 96 T.C. 858, 883-85 (1991).[4] *Truesdell* reasoned that

> [a]s a general proposition, where a taxpayer has dominion and control over diverted funds, they are includable in his gross income under section 61(a) . . . unless some other modifying Code section applies. The latter is the situation here, since Congress has provided that funds (or other property) distributed by a corporation to its shareholders over which the shareholders have dominion and control are to be taxed under the provisions of section 301(c).

89 T.C. at 1298; *see DiZenzo*, 348 F.2d at 125.

Following *Truesdell*, the IRS accepted the application of IRC § 301(c) to diverted funds. The Tax Litigation Division of the IRS recommended acquiescence in the decision. It declared:

> Funds diverted to the shareholder of a wholly owned corporation should be regarded as constructive distributions, unless the funds were additional salary

[4] For a history of the changing positions taken by the Tax Court and the IRS before *Truesdell* concerning the taxation of corporate diversions, see Stephen D. Gardner, *The Tax Consequences of Shareholder Diversions in Close Corporations*, 21 Tax. L. Rev. 223 (1966).

> or otherwise were received in a nonshareholder capacity. The funds should be included in the income of the corporation and taxed to the shareholder in accordance with I.R.C. § 301(c). When such funds are received in a shareholder capacity, we will no longer argue they are ordinary income regardless of earnings and profits.

Truesdell, 89 T.C. 1280, *action on dec.*, AOD 1988-025 (Sept. 12, 1988), *reprinted at* 1988 AOD LEXIS 22; *see id., acq.*, 1988-2 C.B. 1 n.10, *reprinted at* 1988 IRB LEXIS 3924.

The "constructive dividend" approach follows from the definition of "dividend" in IRC § 316(a). That definition--"any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits"--does not require any corporate formalities. Rather, the definition turns on three factors: the distribution must be (1) by a corporation (2) to a shareholder in his capacity as such (3) out of earnings and profits. As long as those circumstances exist, the distribution is a dividend subject to taxation under IRC § 301(c)(1). If the corporation lacks earnings and profits, then the taxation rules in IRC § 301(c)(2) and (c)(3) apply.

II. THE *MILLER* CONTEMPORANEOUS INTENT REQUIREMENT HAS NO STATUTORY BASIS AND DISREGARDS THE TAX DEFICIENCY ELEMENT OF CRIMINAL TAX EVASION.

Despite the apparent simplicity of IRC §§ 301 and 316, the Ninth Circuit has refused in criminal cases to apply those statutes as written. The court requires a criminal defendant not only to produce evidence that the corporation lacked earnings and profits and that the distribution did not exceed his basis in the stock, but also to show an intent by the corporation or the shareholder, at the time of the distribution, to treat it as a return of capital. The Ninth Circuit bases this contemporaneous intent requirement on a purported distinction between criminal and civil tax cases. As we demonstrate in Part II(A) below, that distinction is baseless, and even the government does not appear to defend it.

The government rests its appellate defense of *Miller* on the phrase "with respect to its stock" in IRC § 301(a). *Miller* itself attaches no significance to that phrase, and for good reason. Part II(B) shows that the language on which the government seizes merely distinguishes between corporate distributions to shareholders in some other capacity--salary paid to a shareholder employee, for example, or a debt repayment to a shareholder creditor--and distributions to shareholders in their capacity as such. The phrase "with respect to its stock" thus provides no basis for the *Miller* contemporaneous intent requirement.

A. Section 301 Applies in Criminal Tax Cases As It Does in Civil Tax Cases.

Contrary to *Miller* and the courts below, and consistent with *Bok* and *D'Agostino*, the substantive tax principles in IRC §§ 301 and 316 apply in criminal tax cases just as they do in civil tax cases. The Ninth Circuit erred in *Miller* and in this case in requiring that criminal defendants establish, as a condition to raising the return of capital defense, that the corporation or the taxpayer intended the distribution as a return of capital at the time it was made. This contemporaneous intent requirement has no basis in the statutory text and creates an unwarranted disparity between civil and criminal tax liability.

Criminal tax cases often require the government to prove that the defendant had income that he failed to report. In a prosecution for tax evasion under IRC § 7201, the government must prove the existence of a tax deficiency. *See, e.g., Sansone v. United States*, 380 U.S. 343, 351 (1965); Pet. App. 3. Similarly, in a prosecution under IRC § 7206(1) for subscribing a tax return that understates the taxpayer's income, the government must prove that the income figure on the return is false--that is, that the taxpayer had more income than he reported.

When (as here) the purported income at issue consists of money the defendant diverted from a corporation in which he owns stock, the defendant may invoke IRC §§ 301 and 316. In particular, the defendant may contend--as Boulware sought to do--that the corporation lacked earnings and profits,

that the diversion did not exceed the defendant's basis in his stock, and thus that the diverted funds constitute a nontaxable return of capital under IRC § 301(c)(2), rather than a dividend or other form of income that must be included in gross income under IRC § 61(a). By showing that the diverted money is not income, the defendant seeks to negate the tax deficiency element of IRC § 7201 and the false statement element of IRC § 7206(1).

In response to return of capital claims, some courts have declared that the rules in IRC § 301(c) apply differently in criminal tax cases than they do in civil cases. Apart from *Miller* and the court of appeals' decision here, however, these cases can be read to address the allocation of the burden of proof on the return of capital issue, rather than the applicable substantive principles.[5] The courts hold that the government satisfies its prima facie burden on the tax deficiency element by establishing that the defendant received and controlled the diverted funds. The defendant then has the burden of producing evidence that the corporation lacked earnings and profits and that the distribution at issue did not

[5] *See, e.g., United States v. Peters*, 153 F.3d 445, 460 (7th Cir. 1998) (noting that the majority of courts addressing a return of capital defense in criminal cases "have held that the government need not prove the character of the diverted funds"); *United States v. Williams*, 875 F.2d 846, 849-52 (11th Cir. 1989) (rejecting the defendant's contention that the government had not met its burden of proof on the tax deficiency element because it had failed to prove the existence of earnings and profits); *Davis v. United States*, 226 F.2d 331, 335-36 (6th Cir. 1955) ("While, of course, the burden of proof does not shift in a criminal case, it is the rule that when the government establishes a prima facie case, it is then for the defendant to overcome the inferences reasonably to be drawn from the proven facts.").

exceed the stock basis. In finding the evidence sufficient on the tax counts in Boulware's first appeal, the Ninth Circuit appeared to read *Miller* in this way. Pet. App. 54.

At Boulware's second trial, neither the government nor the district court disputed that Boulware's proffered evidence would meet his burden of production on the earnings and profits and basis aspects of IRC § 301(c). The district court (later affirmed by the court of appeals) held instead that Boulware had failed to produce evidence of an intent by the corporation or the taxpayer, *at the time of the distribution*, to treat it as a return of capital. Pet. App. 5-6 (court of appeals); JA 50-56, 90-92, 137-38 (district court).

This contemporaneous intent requirement began with *Miller*. That case involved the prosecution of a defendant who had diverted money from his closely held corporation to his own benefit. Following a bench trial, the district court found that the funds at issue were salary and thus constituted gross income under IRC § 61. *See* 545 F.2d at 1212. Although it would have been sufficient for affirmance simply to hold that the trial court's finding was not clearly erroneous--a conclusion for which the record provided ample support, *see id.* at 1215-16--the court of appeals elected to discuss the defendant's contention that the diverted funds had to be treated as a return of capital. That discussion as well could have been brief; the defendant failed to meet his burden of producing evidence that the corporation had no earnings and profits, *see id.* at 1213 n.11, and Miller's own expert testified that the

diverted funds exceeded his basis in the stock by $68,800, *see id.* at 1210 n.7.

Rather than limit itself to these points, however, the Ninth Circuit elected to analyze the application of IRC §§ 301 and 316 in criminal tax cases. The court framed the issue as follows: "This court must decide whether the rules of constructive distribution are to be automatically applied in the present situation, a review of a *criminal* tax proceeding." *Miller*, 545 F.2d at 1214. The court identified what it considered a decisive difference between civil and criminal tax cases: "In civil tax cases the purpose is tax collection and the key issue is the establishment of the amount of tax owed by the taxpayer. In a criminal tax proceeding the concern is not over the type or the specific amount of the tax which the defendant has evaded, but whether he has willfully attempted to evade the payment or assessment of a tax." *Id.* The court elaborated on this point:

> The difficulty in *automatically* applying the constructive distribution rules to this case is that it completely ignores one essential element of the crime charged: the willful intent to evade taxes, and concentrates solely on the issue of the nature of the funds diverted. That latter aspect is not the important element. Where the taxpayer has sought to conceal income by filing a false return, he has violated the tax evasion statutes. It does not matter that that amount could have somehow

> been made non-taxable if the taxpayer had proceeded on a different course. To apply the constructive distribution rules to this situation would nullify all of the taxpayer's prior unlawful acts.

Id. In a footnote, the court added: "At the time the funds are initially diverted, it might well be argued that they could constitute either income or a return of capital. However, once the taxpayer has assumed control of the funds and then fails to report such funds as income or to make any adjustments in the corporate books to reflect a return of capital, he has already violated the tax evasion statutes." *Id.* at 1214 n.12.[6]

Miller noted what it described as an "anomalous situation" that would arise "[i]f constructive distribution rules were automatically applied." *Id.* at 1214. According to the court, "[a] taxpayer who diverted funds from his close corporation when it was in the midst of financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in the stock) for failure to report such sums as income; while that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." *Id.*

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[6] In support of this proposition, *Miller* cited *Spies v. United States*, 317 U.S. 492, 498-99 (1943). But nothing in *Spies* supports the *Miller* reasoning. In *Spies* the petitioner "admitted . . . that he had sufficient income during the year in question to place him under a statutory duty to file a return and to pay a tax, and that he failed to do either." *Id.* at 493. Thus, there was no issue in *Spies* concerning the tax deficiency element of tax evasion.

Having rejected "automatic" application of the return of capital rule in criminal tax cases, the Ninth Circuit turned to the circumstances under which it would permit a criminal defendant to raise the rule in defense of a tax evasion charge. The key, in the *Miller* court's view, is the contemporaneous intent of the shareholder and the corporation. The court declared that "[t]o constitute [a return of capital], there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return." *Id.* at 1215. The court made clear that the taxpayer or the corporation must intend a return of capital *at the time of the distribution.* In outlining its reasons for affirming the district court's decision, the court observed that "Miller presented no concrete proof that the amounts were considered, intended, or recorded on the corporate records as a return of capital *at the time they were made.*" *Id.* (emphasis added).

The return of capital analysis in *Miller* and the courts below is wrong for three principal reasons. First, the *Miller* approach "effectively eliminates proof of a tax deficiency as an element of a 26 U.S.C. § 7201 violation." *D'Agostino*, 145 F.3d at 73. In the words of one scholar, *Miller* "completely ignored the fact that one of the three elements in an evasion case is the existence of a tax due and owing." Linda S. Eads, *From Capone To Boesky: Tax Evasion, Insider Trading, and Problems of Proof*, 79 Cal. L. Rev. 1421, 1454 (1991).[7] The "anomaly" *Miller* noted between a

[7] The government stated this position starkly in its objection to Boulware's proposed return of capital instruction. It declared that "[t]ax evaders should not escape criminal liability simply

defendant whose corporation had earnings and profits and one whose corporation did not is no anomaly at all; it is the difference between a defendant who violated the tax evasion statute and one who did not. In the words of *D'Agostino*, "The diversion of the funds cannot constitute a criminal offense, despite criminal intent, if no taxes are due." 145 F.3d at 73. By reading the tax deficiency element out of IRC § 7201, *Miller* reduces the prosecution's burden of proof and thus violates the defendant's right to due process.

Second, as Judge Thomas recognized in his concurrence below, the *Miller* contemporaneous intent requirement produces an unwarranted anomaly: corporate distributions that do not count as income for civil tax purposes under the return of capital rule *do* count as income for purposes of the tax evasion and tax perjury statutes. Pet. App. 13-14; *see, e.g., D'Agostino*, 145 F.3d at 73. Thus, under the Ninth Circuit's approach, a shareholder who has no income under IRC § 301(c) and *Truesdell* and who therefore has no tax liability could nevertheless be found to have a tax deficiency under IRC § 7201 and to have falsely reported his (nonexistent) income under IRC § 7206(1).

In other words, in the civil setting, a corporate distribution to a shareholder in his capacity as such

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(continued...)

because the intricacies of tax law result in no tax due and owing." JA 40. What the government and the Ninth Circuit overlook is that the existence of a "tax due and owing" *is an element of the offense of tax evasion.*

is a nontaxable return of capital, regardless of the intent of the taxpayer and the corporation at the time of the distribution, as long as the corporation has no earnings or profits and the distribution does not exceed the taxpayer's basis in his stock. But according to the Ninth Circuit, that same distribution constitutes income for purposes of a criminal prosecution unless the taxpayer can show that, at the time of the distribution, he and the corporation intended a return of capital. The contemporaneous intent requirement thus "result[s] in a logical fallacy, [and] is in flat contradiction with the tax evasion statute's requirement of 'the existence of a tax deficiency.'" Pet. App. 13-14 (Thomas, J., concurring).[8]

The substantive rules under which a court determines whether tax is owed should not vary depending on whether the case is criminal or civil. The government conceded in its opposition to the petition for certiorari that IRC § 301 "applies equally

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[8] The Ninth Circuit's analysis in *Noble v. Commissioner*, 368 F.2d 439 (9th Cir. 1966), highlights that court's disparate treatment of civil and criminal tax cases. In *Noble*, a civil case, the government argued that payments by a corporation to shareholders were taxable constructive dividends, rather than nontaxable loan repayments as the shareholders contended. The parties stipulated that neither the corporation nor the shareholders intended the payments to constitute dividends. *See id.* at 443. The court of appeals declared that "[the] intention of the parties is not controlling" and that "[t]o constitute a distribution taxable as a dividend, the benefit received by the shareholder need not be considered as a dividend either by the corporation or its shareholders . . . ." *Id.* (quotation omitted). Thus, *Miller* treats the contemporaneous intent of the corporation and the shareholder as decisive in a criminal tax case, while *Noble* disregards that intent in a civil tax case.

to civil and criminal tax proceedings." Brief for the United States in Opposition at 15. As three Members of this Court remarked in terms equally applicable here, "It is true that the Government brought a criminal evasion prosecution rather than a civil deficiency proceeding against petitioner, but this can in no way alter the substantive tax law rules which alone are determinative of liability in either case." *James v. United States*, 366 U.S. 213, 253 (1961) (Whittaker, Black, and Douglas, JJ., concurring in part and dissenting in part); *cf. Nordstrom v. United States*, 360 F.2d 734, 735 (8th Cir. 1966) ("To be criminally liable on this charge [tax evasion], it first must appear that appellant was under a civil liability to pay the tax.").

By engrafting the contemporaneous intent requirement on IRC §§ 301 and 316 in *Miller*, the Ninth Circuit created an impermissible and illogical dichotomy between civil and criminal cases. If anything, tax statutes in a criminal setting should be interpreted, to the extent they reasonably can be, in the defendant's favor. *Cf. United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 518 (1992) (plurality opinion) (applying rule of lenity to potentially criminal tax statute applied in civil setting); *White v. Aronson*, 302 U.S. 16, 20 (1937) ("Where there is a reasonable doubt as to the meaning of a taxing Act it should be construed most favorably to the taxpayer."). *Miller* erroneously reverses that interpretive principle.

Third, the *Miller* contemporaneous intent requirement lacks any basis in the statutory text. The language of IRC §§ 301 and 316 gives no hint

that the return of capital rule requires an intent by the taxpayer or the corporation, at the time of the distribution, to treat it as a return of capital.

In fact, IRC § 316 by its terms establishes that the shareholder and the corporation often do not know at the time of the distribution whether it is a taxable dividend or a nontaxable return of capital. IRC § 316(a)(2) defines "dividend" as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits of the taxable year (*computed as of the close of the taxable year* without diminution by reason of any distributions made during the taxable year), *without regard to the amount of the earnings and profits at the time the distribution was made*." (Emphasis added.)

As the emphasized language shows, earnings and profits for purposes of § 316(a)(2) cannot be determined until the "close of the taxable year," which may be months after the distribution occurs. Moreover, the earnings and profits determination must be made "without regard to the amount of the earnings and profits at the time the distribution was made." IRC § 316(a)(2). "This means that a distribution will be a 'dividend' if the corporation has earnings and profits at the end of the current taxable year, even though it had none when the distribution occurred; conversely, a distribution that seemed to be a 'dividend' when made may turn out to be a return of capital because the corporation has no earnings and profits at the end of the year or for prior years." 1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and*

Shareholders ¶ 8.02[2], at 8-12 (7th ed. 2006). Because the shareholder and the corporation may not know until long after the distribution whether it is a dividend or a return of capital, it makes no sense--and is contrary to the statutory scheme--to require a contemporaneous intent that the distribution be a return of capital.

The approach of the Second Circuit in *D'Agostino* and *Bok* squares with the language of IRC §§ 301 and 316 and suffers none of the infirmities of the *Miller* contemporaneous intent approach. *D'Agostino* and *Bok* recognize that a tax deficiency is an element of the offense of tax evasion under IRC § 7201; that the same substantive rules for determining income apply in criminal and civil tax cases; and that, under IRC §§ 301 and 316, the tax status of corporate funds diverted to a shareholder in his capacity as such depends exclusively on whether the corporation had earnings and profits and the extent of the shareholder's basis in his stock.

D'Agostino and *Bok* make clear that, for IRC § 301(c)(2) to apply, the shareholder and the corporation need not have intended the diverted funds to be a return of capital at the time of the diversion. As *Bok* explained,

> [I]n return of capital cases, a taxpayer's intent is not determinative in defining the taxpayer's conduct. That is, the taxpayer or the corporation need not have described the distribution at issue as a dividend or a return of capital at the time it was made; rather, the

> realities of the transaction--including the amount of the shareholder's basis and the corporation's earnings or profits, as well as the amount of the distribution--govern its characterization for tax purposes.

156 F.3d at 162; *see D'Agostino*, 145 F.3d at 72-73. Because *Bok* and *D'Agostino* hew faithfully to the statutory text, the Court should adopt their interpretation of IRC §§ 301 and 316.

B. The Phrase "With Respect To Its Stock" in Section 301(a) Does Not Support the Court of Appeals' Decision.

The government argued in its opposition to certiorari that the phrase "with respect to its stock" in IRC § 301(a) supports the *Miller* approach to the return of capital rule. Brief for the United States in Opposition at 12-13. This contention is implausible on its face. Although *Miller* alludes to that phrase in passing, *see* 545 F.2d at 1210 n.5, the Ninth Circuit never cites it as a basis for the contemporaneous intent requirement. The court of appeals in this case did not even mention the language that the government now claims is decisive. Pet. App. 3-6.

This silence is not surprising. The phrase "with respect to its stock" serves merely to distinguish money that a taxpayer receives from a corporation in his capacity as a shareholder from money that he receives in some other capacity--as an employee, for example, or as a creditor. *See* 26

C.F.R. § 1.301-1(c) ("Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."); S. Rep. 1622, 83d Cong., 2d Sess. 231 (1954) ("Subsection (a) accordingly makes clear that section 301 has applicability only to distributions of property to shareholders in their capacity as such. For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301."). As Professors Bittker and Eustice explain, "Even though such transfers are 'distributions,' in the sense of being transfers, they are not made to a shareholder 'with respect to [his] stock,' as required by § 301(a), because the corporation receives equal value . . . ; hence, the tax consequences of such transfers are governed by other sections of the Code." 1 Bittker & Eustice, *supra*, ¶ 8.05[1], at 8-39 (footnote omitted).

Apart from *Miller* and its progeny in the criminal context, courts do not define constructive dividends (or other distributions "with respect to [a corporation's] stock") in terms of the intent of the corporation or the shareholder. Rather, a constructive dividend exists "if the corporation confers a direct benefit on [the shareholder] from available earnings and profits without expectation of repayment." *Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 221, 231-32 (3d Cir. 2002). As the Tax Court has recognized, "Where a corporation confers an economic benefit on a shareholder without the expectation of repayment, that benefit becomes a constructive dividend, taxable to the shareholder,

even though neither the corporation nor the shareholder intended a dividend." *Magnon v. Commissioner*, 73 T.C. 980, 993-94 (1980) (emphasis added); *see, e.g., Dynamics Corp. of America v. United States*, 392 F.2d 241, 247 (Ct. Cl. 1968) ("It is not the intent of the parties that governs the characterization of the distribution, but rather the economic and consequent legal effect of their actions.").

The government correctly notes that the intent of the shareholder and the corporation may be significant in determining whether a payment constitutes salary, a loan repayment, or some other form of distribution in a nonshareholder capacity. Brief for the United States in Opposition at 12-15. From this sound premise, however, the government makes an unwarranted leap. It concludes that intent is *also* important in establishing that a distribution is "with respect to [a corporation's] stock." That is wrong.

If a party to a tax controversy contends that a distribution to a shareholder should *not* be treated as subject to IRC § 301(c)--if a party contends, for example, that the distribution should be treated as salary, or a loan repayment, or a loan--then that party may well have the burden of producing evidence of a corresponding intent. *See, e.g., Crowley v. Commissioner*, 962 F.2d 1077, 1079 (1st Cir. 1992) ("A shareholder distribution is a loan, rather than a constructive dividend, if at the time of its disbursement the parties intended that it be repaid."); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1244-45 (9th Cir. 1983) (requiring evidence of

"compensatory intent" where distribution was alleged to be compensation); *King's Court Mobile Home Park, Inc. v. Commissioner*, 98 T.C. 511, 514 (1992) (same). But where there is no evidence of such intent (or no evidence of intent at all), courts (other than *Miller* and its progeny) treat a corporate distribution to a shareholder under the taxation rules of IRC § 301(c). To express this point in terms of IRC § 301(a), courts infer that a corporate distribution to a shareholder is "with respect to its stock" and thus subject to IRC § 301(c) unless there is evidence to the contrary.

In this case, neither party contended in the district court that the $10 million HIE distributed to Boulware constituted salary or some other form of compensation.[9] No evidence was presented of "compensatory intent." And, although Boulware contended in the alternative that some of the distributions were repayments of loans he had made to HIE, the government disputed this characterization. The government never contended in the district court that the HIE distributions at issue were other than "with respect to its stock." The government's

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[9] It is not surprising that neither party took this position. From Boulware's perspective, salary or other compensation constitutes gross income under IRC § 61(a). From the IRS' perspective, characterizing the diverted funds as compensation to Boulware would ensure taxability at his level but would allow HIE a deduction under IRC § 162(a). Characterizing the diverted funds as constructive dividends, by contrast, denies HIE a compensation deduction and also permits taxation of Boulware to the extent HIE had earnings and profits or the distribution exceeded Boulware's basis in his stock. *See, e.g., Neonatology Associates*, 299 F.3d at 231-32 (IRS argues successfully that distributions to shareholders are constructive dividends rather than compensation and thus nondeductible by the corporation); *King's Court Mobile Home Park, Inc.*, 98 T.C. at 514-15 (same).

sole (and successful) contention was that Boulware could not establish a contemporaneous intent to treat the distributions as a return of capital, as *Miller* requires, and thus that he could not assert the return of capital defense. That was the district court's sole basis for precluding the defense and the court of appeals' sole basis for affirmance. Because the *Miller* contemporaneous intent requirement has no textual basis and improperly distinguishes between criminal and civil tax cases, the Court should reject it in favor of the better-reasoned *Bok* and *D'Agostino* approach.

III. SECTION 301 APPLIES TO UNLAWFUL DIVERSIONS.

The government argues in the alternative that the taxation principles in IRC § 301(c) do not apply to "unlawful" shareholder diversions of corporate assets. In the district court, however, "the government did not allege or prove that [Boulware's] diversions of corporate funds were unlawful." *D'Agostino*, 145 F.3d at 73 (refusing to apply "unlawfulness" exception to return of capital rule absent such proof). Nor did the government contest the lawfulness of the HIE diversions to Boulware before the Ninth Circuit panel. Judge Thomas raised that issue for the first time in his concurrence. Pet. App. 14.[10] Seizing on Judge

[10] Judge Thomas asserted that "[b]ecause Boulware claimed that the diversions were made to defraud his ex-wife from her share of property in the diverce proceedings, these diversions may properly be considered unlawful." Pet. App. 14 (citing *Boulware*, 384 F.3d at 801). But the language Judge Thomas cited from *Boulware* does not support a finding that Boulware obtained the money from HIE to defraud his ex-wife, or even that he "claimed" to have done so. The district court made no

Thomas' suggestion, the government argued in its oppositions to rehearing en banc and certiorari that Boulware's diversions were unlawful and thus could not be considered returns of capital. In particular, the government suggested that Boulware had breached his fiduciary duty to the trust he established for his son, which held fifty percent of the HIE stock, and that he had diverted the funds to defraud his wife in their divorce. *See* Brief for the United States in Opposition at 16-17.[11]

The Court should reject the proposed "unlawfulness" exception to the normal operation of IRC §§ 301 and 316. Nothing in the language of those statutes supports different tax treatment of lawful and unlawful shareholder diversions. The characterization of a diversion for tax purposes turns solely on the factors that the statutes identify--the amount of earnings and profits, the shareholder's basis in the stock, and the size of the distribution. In the absence of statutory language distinguishing lawful transactions from unlawful transactions, they must be treated the same for tax purposes.

(continued...)

finding that the distributions from HIE to Boulware were for that purpose. In any event, the issue, to the extent it is material, must be decided by a jury.

[11] The government also contended that Boulware's conspiracy conviction in his first trial established that he "diverted corporate funds in furtherance of a conspiracy to make false statements to a federally insured institution." Brief for the United States in Opposition at 17. But Boulware's conspiracy conviction establishes only that he conspired to obtain funds unlawfully *from a federally insured financial institution.* It does not establish that Boulware unlawfully diverted funds *from HIE.*

James illustrates this point. In that case, the Court rejected a taxpayer's contention that embezzled funds did not constitute "gross income" under IRC § 61. Although the opinions in *James* (none of which commanded a majority) reached varying conclusions, none disputed that the core question was whether embezzled funds should be included in the statutory term "gross income." *See, e.g., James*, 366 U.S. at 213 (plurality opinion); *id.* at 222-23 (Black & Douglas, JJ., dissenting); *id.* at 241 (Clark, J., concurring in part and dissenting in part). No Justice suggested that the language of IRC § 61 could be disregarded or expanded because the funds at issue had been unlawfully obtained.

Some cases have suggested in dictum that the return of capital principles in IRC §§ 301(c)(2) and 316 "would not necessarily apply in a case of unlawful diversion, such as embezzlement, theft, a violation of corporate law, or an attempt to defraud third party creditors." *D'Agostino*, 145 F.3d at 73; *see, e.g., Bok*, 156 F.3d at 162 n.1 (same); *Truesdell*, 89 T.C. at 1298 ("In this case petitioner's diversions of income . . . were not per se unlawful. The diverted funds were not, at least on their face, stolen, embezzled or diverted in fraud of creditors. There has been no suggestion that the diversions were improper as a matter of corporate law."); *DiZenzo*, 348 F.2d at 125 (same). But these cases provide no textual analysis or other support for any such "unlawfulness" exception to the taxation principles in IRC §§ 301(c) and 316. No case since *Truesdell* squarely holds that such an exception exists.

It is possible to imagine circumstances in which a shareholder's unlawful appropriation of corporate funds would not fall within the language of IRC §§ 301 and 316. If a General Motors shareholder broke into corporate headquarters and stole money from petty cash, for example, that would not be a constructive dividend, because the theft would not constitute a "distribution" by the corporation to the shareholder "with respect to its stock." Instead, the stolen funds would be directly includable in gross income under IRC § 61(a) as construed in *James*. Such an appropriation would be excluded from IRC §§ 301 and 316 not because it is unlawful, but because it does not fall within the statutory language. But when a shareholder with control over a corporation diverts corporate funds to himself, whether lawfully or unlawfully, the taxation rules of IRC §§ 301 and 316 control.

The decision in *Drybrough v. Commissioner*, 238 F.2d 735 (6th Cir. 1956), illustrates this point. In *Drybrough*, the holders of 80 percent of the stock of a close corporation diverted corporate funds to themselves. The wife of one of the shareholders--who held 20 percent of the stock--did not know about the diverted funds. The court of appeals found that, despite the possible fraud upon the unwitting shareholder, the taxation rules in the predecessors to IRC §§ 301 and 316 controlled. The court noted that the shareholders "were not employees who embezzled from an unwitting employer, but officers, directors and stockholders in complete domination and control of their corporation." 238 F.2d at 738. It added that "even though received by petitioners under a claim of right, the funds are taxable as

dividends only to the extent that the corporation had earnings and profits for the years in which they were withdrawn." *Id.* The court concluded that "[t]o the extent of earnings and profits thus determined the diverted funds will be taxed to petitioners as ordinary income in the years received. Withdrawals in excess of earnings and profits will be taxed as capital gains after the adjusted basis of petitioners' stock has been exhausted." *Id.* at 740. *Drybrough* reflects a straightforward application of the IRC § 301(c) taxation rules to an unlawful diversion.

Even if the Court determines that some forms of unlawful diversion do not fall within the terms of IRC §§ 301 and 316 (such as the shareholder theft from General Motors described above), that provides no basis for affirming Boulware's conviction. Boulware (like every other criminal defendant) has a Fifth and Sixth Amendment right to a jury determination beyond a reasonable doubt on every fact essential to a finding of guilt. *See, e.g., United States v. Booker*, 543 U.S. 220, 230 (2005); *United States v. Gaudin*, 515 U.S. 506, 509-15 (1995); *In re Winship*, 397 U.S. 358, 364 (1970). A tax deficiency is an essential element of the tax evasion charges, and a false statement--alleged here to be an understatement of income--is an essential element of the tax perjury charges. To the extent the government seeks to overcome Boulware's return of capital defense on those elements by showing that his diversion of HIE funds was unlawful, it must prove the unlawful conduct to a jury beyond a reasonable doubt.

The government has never been put to its proof on unlawfulness, before a jury or otherwise. Thus, if the Court concludes that some or all unlawful diversions do not fall within IRC §§ 301 and 316, the proper course is not to engage in appellate factfinding, but to reverse and remand for a new trial at which both parties can present evidence to a jury on the unlawfulness issue. *See, e.g., Sullivan v. Louisiana*, 508 U.S. 275, 280 (1993).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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In The

Supreme Court of the United States

MICHAEL H. BOULWARE,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

JOINT APPENDIX

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Date Filed	#	Docket Text
05/19/1999	1	EP: INDICTMENT by USA Counts filed against Michael H. Boulware (1) count(s) 1-4, 5, 6-9, 10; PS ordered (Maryann Shawler) by Mag Judge YAMASHITA (gab) Modified on 05/19/1999 Additional attachment(s) added on 6/13/2006 (bbb,). (Entered: 05/19/1999)
02/14/2001	167	EP: SUPERSEDING INDICTMENT by USA; naming Michael H. Boulware counts filed against Michael H. Boulware (1) count(s) 1ss-6ss, 7ss, 8ss, 9ss, 10ss, 11ss, 12ss, 13ss, 14ss, 15ss-18ss, 19ss ordered (Bruce Gettman) by Mag Judge CHANG (gab) Additional attachment(s) added on 6/13/2006 (bbb,). (Entered: 02/15/2001)
11/29/2001	302	EP: MINUTES: Further Jury Deliberation (4th Day) – 12 Jurors present. Court read the Verdict in open Court – Defendant Present not in Custody and Also present the 12 Jurors. Defendant was found Guilty as to Cts 1, 2, 3, 4, 5, 6, 7, 8, 9 & 10 and Not Guilty as to Cts 11, 12, 13 & 14. Jurors were polled. . . . (Ct Rptr: Stephen Platt) by Judge Rafeedie (gs) (Entered: 12/04/2001)

05/06/2002	352	EP: MINUTES: Sentence as to Counts 1 through 10 and Various Motions – Deft present not in custody; Deft's Motion for New Trial – DENIED; Deft's Motion for Judgment of Acquittal – DENIED; Govt's Entry of forfeiture (as to Count 19 of the Second Superseding Indictment) – (money judgment) – GRANTED; The Court adopts the factual findings and guideline application in the presentence report except as to certain facts and issues that were stated for the record and reflected on the Statement of Reasons; Deft request for Downward Departure – Granted in Part and Denied in part; Deft addresses the Court; Sentence as to Counts 1 through 10 – [346-1], [336-1], [310-1], [307-1] Imprisonment – 36 Months as to each of Counts 1 to 5, 51 Months as to each of Counts 6 to 9 and 51 Months to Count 10 such terms to run concurrently with each other Supervised Release – 1 Year as to each of Counts 1 to 5 and 3 years as to each of Counts 6 to 10 all terms to run concurrently. . . . (Ct Rptr: Cynthia Fazio) by Judge Rafeedie (gs) (Entered: 05/17/2002)
01/21/2005	381	APPEAL Judgment from 9CCA reversing and remanding the Decision of the District Court

		[Appeal [353-1] filed and entered: 9/14/2004 Attest date: 1/14/2005 (cc: all counsel, USPO, USM, Judge, Mag Judge, CRD) as to CA 02-10287; reverse Boulware's conviction for tax evasion and filing false tax returns and affirm his conviction for conspiracy to make false statements to a federally insured financial instutution; vacate his sentence on the false statement count and remand for further proceedings consistent with this opinion (eps) Additional attachment(s) added on 7/25/2006 (bbb). Entered: 01/25/2005)
06/20/2005	407	Proposed SUPPLEMENTAL jury instructions (redacted set); certificate of service – by defendant Michael H. Boulware [406-1] (lmg) (Entered: 06/21/2005)
06/23/2005	414	United States' OBJECTIONS to Defendant's proposed supplemental jury instructions [407-1]; certificate of service (bbb) (Entered: 06/27/2005)
06/30/2005	425	United States MOTION in limine to Preclude Defendant From Introducing evidence, testimony and argument relating to the issues of constructive distributions and returns of capital as to Michael H. Boulware (gs) (Entered: 06/30/2005)

06/30/2005	427	MEMORANDUM in support of motion in limine to Preclude Defendant From Introducing evidence, testimony and argument relating to the issues of constructive distributions and returns of capital as to Michael H. Boulware [425-1] by plaintiff USA (gs) (Entered: 06/30/2005)
07/01/2005	428	MEMORANDUM in opposition to motion in limine to Preclude Defendant From Introducing evidence, testimony and argument relating to the issues of constructive distributions and returns of capital filed on June 30, 2005; certificate of service [425-1] by defendant Michael H. Boulware (eps) (Entered: 07/05/2005)
07/05/2005	433	Notice of Motion and MOTION for leave to present evidence of reporting of excess income by HIE, offer of proof and request for FRE Rule 104 hearing by defendant Michael H. Boulware – referred to Judge Edward Rafeedie (lmg) (Entered: 07/06/2005)
07/01/2005	446	EP: MINUTES: Further Jury Trial Date-(5th Day)-Defendant present not in Custody. Also present 12 Jurors and 2 Alternate Jurors. Defendant Witnesses-Sidney Boulware-CST, James

Chan-Previously Sworn in, Michael McCarthy-Previously Sworn in and Stanley Wachi-CST. Defendant's Exhibits-1000, 1001, 1002, 1003, 1005, 1006, 1007, 1008 and 1682-Admitted. Deft's Motion for leave to present evidence of reporting of excess income by HIE, offer of proof and request for FRE Rule 104 Hearing-is hereby Denied [438-1]. Government's Motion in Limine to preclude Defendant from introducing evidence testimony and argument relating to the issues of constructive distributions and returns of capital-is hereby Granted [425-1].

07/06/2005	439	MEMORANDUM in opposition to defendant's motion for leave to present evidence of reporting of excess income by HIE, offer of proof and request for F.R.E. 104 hearing; certificate of service [438-1] – by plaintiff (lmg) (Entered: 07/06/2005)
07/15/2005	456	EP: MINUTES: Further Jury Deliberations (2nd Day) – 12 Jurors present. Return of the Verdict-Defendant present not in Custody and 12 Jurors are also present. As to Count 1, 2, 3, 4, 5,6, 7, 8 and 9 – Guilty as to each of these counts. Jurors were

polled. . . . (Ct Rptr: Stephen Platt) by Judge Edward Rafeedie (eps) (Entered: 07/25/2005)

10/24/2005 477 EP: MINUTES: Sentence as to Counts 1 2, 3, 4, 5, 6, 7, 8, 9 and 10 of the Second Superseding Indictment, Defendant's Request for Downward Departure and Defendant's Motion for Release pending Appeal – Defendant present not in Custody. The Court adopts the presentence report and guideline applications but with some changes. Defendant's Request for Downward Departure – Granted in Part and Denied in Part.

Defendant addresses the Court. sentencing Michael H. Boulware (1) count(s) 1 ss-5ss, 7ss, 9ss, 10ss. Sentence as to Counts 1, 2, 3, 4, 5, 6, 7, 8, 9 and 10 of the Second Superseding – Imprisonment – 36 Months as to each of Counts 1 through 5, such terms to run concurrently with each other. 60 Months as to each of Counts 6 through 10, such terms to run concurrently with each other, all terms to run Court will allow the Defendant to self surrender to the prison facility designated by the Bureau of Prison. Stayed to January 05, 2006 by 2:00 p.m. Local Time. . . . (Ct Rptr: ESR/B Biacan)

		by Judge Edward Rafeedie (eps) (Entered: 10/27/2005)
10/27/2005	482	JUDGMENT and Commitment as to Michael Boulware by Judge Edward Rafeedie (cc: all counsel) (ecs) Additional attachment(s) added on 8/4/2006 (tbf,). Entered: 11/04/2005)
11/02/2005	483	NOTICE OF APPEAL by defendant Michael H. Boulware regarding [482-1] fees paid (receipt #232428) (ecs) (Entered: 11/15/2005)

U.S. COURT OF APPEALS - 9TH CIRCUIT

05-10752 USA v. Boulware

12/13/06	FILED OPINION: AFFIRMED (Terminated on the Merits after Oral Hearing; Affirmed; Written, Signed, Published. Pamela A. RYMER, author; Sidney R. THOMAS, concurring; Stephen G. Larson.) FILED AND ENTERED JUDGMENT. [05-10752] (ba) [05-10752]
4/23/07	Filed order (Pamela A. RYMER, Sidney R. THOMAS, Stephen G. Larson,): The petition for rehearing and the petition for rehearing en banc are DENIED. [6043476-1] [05-10752] (ba) [05-10752]
5/1/07	MANDATE ISSUED [05-10752] (ba) [05-10752]

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UNITED STATES OF AMERICA

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA Plaintiff, v. MICHAEL H. BOULWARE, Defendant.	CR. NO. 99-00239 DAE SECOND SUPERSEDING INDICTMENT [26 U.S.C. §§ 7206(1) and 7201; 18 U.S.C. §§ 371, 1014, and 982]

SECOND SUPERSEDING INDICTMENT

(Filed Feb. 14, 2001)

COUNT 1

The Grand Jury charges:

On or about June 8, 1993, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully make and subscribe a Form 1040 U.S. Individual Income Tax Return for the calendar year 1989, which was filed over three years late with the Internal Revenue Service and was false as to a material matter and verified by a written declaration that it was made under the penalties of perjury, which said income tax return he did not believe to be true and correct as to every material matter in that his income tax return reported total income of $207,522.00, whereas defendant MICHAEL H. BOULWARE then and there well new and believed that his total income was substantially in excess of that reported amount as his income

tax return omitted additional total income of approximately $1,072,000.00.

All in violation of Title 26, United States Code, Section 7206(1).

COUNT 2

The Grand Jury further charges:

On or about June 8, 1993, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully make and subscribe a Form 1040 U.S. Individual Income Tax Return for the calendar year 1990, which was filed over two years late with the Internal Revenue Service and was false as to a material matter and verified by a written declaration that it was made under the penalties of perjury, which said income tax return he did not believe to be true and correct as to every material matter in that his income tax return reported total income of $513,495.00, whereas defendant MICHAEL H. BOULWARE then and there well knew and believed that his total income was substantially in excess of that reported amount as his income tax return omitted additional total income of approximately $917,000.00.

All in violation of Title 26, United States Code, Section 7206(1).

COUNT 3

The Grand Jury further charges:

On or about June 8, 1993, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully make and subscribe a Form 1040 U.S. Individual Income Tax Return for the calendar year 1991, which was filed late with the Internal Revenue Service and was false as to a material matter and verified by a written declaration that it was made under the penalties of perjury and which said income tax return he did not believe to be true and correct as to every material matter in that his income tax return reported total income of $684,808.00, whereas defendant MICHAEL H. BOULWARE then and there well knew and believed that his total income was substantially in excess of that reported amount as his income tax return omitted additional total income of approximately $1,927,000.00.

All in violation of Title 26, United States Code, Section 7206(1).

COUNT 4

The Grand Jury further charges:

On or about June 8, 1993, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully make and subscribe a Form 1040 U.S. Individual Income Tax Return for the calendar year 1992, which was filed

late with the Internal Revenue Service, was false as to a material matter and verified by a written declaration that it was made under the penalties of perjury and which said income tax return he did not believe to be true and correct as to every material matter in that his income tax return reported total income of $739,225.00, whereas defendant MICHAEL H. BOULWARE then and there well knew and believed that his total income was substantially in excess of that reported amount as his income tax return omitted additional total income of approximately $1,556,000.00.

All in violation of Title 26, United States Code, Section 7206(1).

COUNT 5

The Grand Jury further charges:

On or about August 15, 1994, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully make and subscribe a Form 1040 U.S. Individual Income Tax Return for the calendar year 1993, which was filed with the Internal Revenue Service and was false as to a material matter and verified by a written declaration that it was made under the penalties of perjury, which said income tax return he did not believe to be true and correct as to every material matter in that his income tax return reported total income of $1,443,990.00, whereas defendant MICHAEL H. BOULWARE then and there well knew and believed

that his total income was substantially in excess of that reported amount as his income tax return omitted additional total income of approximately $1,092,000.00.

All in violation of Title 26, United States Code, Section 7206(1).

COUNT 6

The Grand Jury further charges:

On or about October 15, 1995, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully attempt to evade and defeat a large part of the income tax due and owing by him to the United States of America for the calendar year 1994, by signing and causing to be signed, a false and fraudulent Form 1040 U.S. Individual Income Tax Return, filed with the Internal Revenue Service, by diverting money from Hawaiian Isles Enterprises, Inc. to himself through the use of Automated Equipment, Ltd., a Hawaii corporation wholly owned by defendant MICHAEL H. BOULWARE, for the purpose of concealing additional unreported taxable income received by defendant MICHAEL H. BOULWARE during the calendar year 1994, for which his reported taxable income was the sum of $960,199.00, whereas, he then and there well knew and believed his unreported taxable income for that year was approximately $1,312,595.00, on which said taxable income there was due and owing to the

United States of America an income tax of $519,788.00.

All in violation of Title 26, United States Code, Section 7201.

COUNT 7

The Grand Jury further charges:

On or about September 30, 1996, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully attempt to evade and defeat a large part of the income tax due and owing by him to the United States of America for the calendar year 1995, by signing and causing to be signed, a false and fraudulent Form 1040 U.S. Individual Income Tax Return, which was filed with the Internal Revenue Service, by diverting money from Hawaiian Isles Enterprises, Inc. to himself through the use of Automated Equipment, Ltd., a Hawaii corporation wholly owned by defendant MICHAEL H. BOULWARE, and by diverting money from Hawaiian Isles Enterprises, Inc. to himself through the use of off-shore bank accounts located in Hong Kong and the Kingdom of Tonga, for the, purpose of concealing additional unreported taxable income received by defendant MICHAEL H. BOULWARE during the calendar year 1995, for which his reported taxable income was the sum of $317,858.00, whereas, he then and there well knew and believed his unreported taxable income for that year was approximately $1,095,258.00, on which said taxable income there

was due and owing to the United States of America an income tax of $433,722.00.

All in violation of Title 26, United States Code, Section 7201.

COUNT 8

The Grand Jury further charges:

On or about August 7, 1997, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully attempt to evade and defeat a large part of the income tax due and owing by him to the United States of America for the calendar year 1996, by signing and causing to be signed, a false and fraudulent Form 1040 U.S. Individual Income Tax Return, which was filed with the Internal Revenue Service, by diverting money from Hawaiian Isles Enterprises, Inc. to himself through the use of off-shore bank accounts located in Hong Kong and the Kingdom of Tonga, for the purpose of concealing additional unreported taxable income received by defendant MICHAEL H. BOULWARE during the calendar year 1996, for which his reported taxable income was the sum of $833,709.00, whereas, he then and there well knew and believed his unreported taxable income for that year was approximately $898,293.00, on which said taxable income there was due and owing to the United States of America an income tax of $355,724.00.

All in violation of Title 26, United States Code, Section 7201.

COUNT 9

The Grand Jury further charges:

On or about October 14, 1998, in the District of Hawaii, defendant MICHAEL H. BOULWARE, a resident of Honolulu, Hawaii, did willfully attempt to evade and defeat a large part of the income tax due and owing by him to the United States of America for the calendar year 1997, by signing and causing to be signed, a false and fraudulent Form 1040 U.S. Individual Income Tax Return, which was filed with the Internal Revenue Service, by diverting money from Hawaiian Isles Enterprises, Inc. to himself through the use of off-shore bank accounts located in Hong Kong, for the purpose of concealing additional unreported taxable income received by defendant MICHAEL H. BOULWARE during the calendar year 1997, for which his reported taxable income was the sum of $1,173,617.00, whereas, he then and there well knew and believed his unreported taxable income for that year was approximately $73,243.00, on which said taxable income there was due and owing to the United States of America an income tax of $29,004.00.

All in violation of Title 26, United States Code, Section 7201.

DATED: February 14, 2001, at Honolulu, Hawaii.

A TRUE BILL

/s/ [Illegible]
FOREPERSON, GRAND JURY

/s/ Steven S. Alm
STEVEN S. ALM
United States Attorney
District of Hawaii

/s/ [Illegible]
ELLIOT ENOKI
First Assistant U.S. Attorney

/s/ J. Michael Seabright
LESLIE E. OSBORNE
J. MICHAEL SEABRIGHT
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Assistant U.S. Attorneys

/s/ Edward E. Groves
EDWARD E. GROVES
Special Attorney
U.S. Department of Justice, Tax Division

USA v. MICHAEL H. BOULWARE
Cr. No. 99-00239 DAE; "Second Superseding Indictment"

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, v. MICHAEL H. BOULWARE, Defendant.	CR. NO. 99-00239 ER MEMORANDUM IN SUPPORT OF MOTION *IN LIMINE* TO PRECLUDE DEFENDANT FROM INTRODUCING EVIDENCE, TESTIMONY AND ARGUMENT RELATING TO THE ISSUES OF CONSTRUCTIVE DIVIDENDS AND RETURNS OF CAPITAL

MEMORANDUM IN SUPPORT OF MOTION *IN LIMINE* TO PRECLUDE DEFENDANT FROM INTRODUCING EVIDENCE, TESTIMONY AND ARGUMENT RELATING TO THE ISSUES OF CONSTRUCTIVE DIVIDENDS AND RETURNS OF CAPITAL

(Filed Jun. 30, 2005)

The United States of America, by and through the undersigned attorney, files this memorandum in support of its Motion *In Limine* to Preclude Defendant from Introducing Evidence, Testimony and Argument Relating to the Issue of Constructive Dividends and Returns of Capital.

Based on the evidence and testimony offered thus far, it appears that the defendant intends to offer evidence, testimony and argument relating to the issue of constructive dividends and returns of capital. Such evidence, testimony and argument should be precluded because it is irrelevant in a criminal tax prosecution.

In *United States v. Miller*, 545 F. 2d 1204 (9th Cir. 1976), the Ninth Circuit held that the civil tax rules relating to the complex issues of constructive dividends and returns of capital do not automatically apply in criminal tax evasion prosecutions. *United States v. Miller*, 545 F. 2d 1204, 1214 (9th Cir. 1976). In *Miller*, the defendant was tried and convicted of tax evasion. On appeal, the defendant challenged the conviction contending that the money he had diverted to himself was not income. More specifically, the defendant maintained that the diverted moneys should be treated as constructive dividends and analyzed in accordance with the relevant Internal Revenue Code sections that govern such distributions. *United States v. Miller*, 545 F. 2d 1204, 1211-12 (9th Cir. 1976). Under those relevant sections, the defendant claimed, it can only be considered a dividend, and thus income to him, if the company had corporate earnings. *Id.* Because the corporation did not have earnings during the prosecution years, the defendant maintained that the diverted funds should be considered returns of capital and thus nontaxable. *United States v. Miller*, 545 F. 2d 1204, 1211-12 (9th Cir. 1976).

The Ninth Circuit rejected the defendant's contention noting that the issue in a tax fraud case is "not over the specific amount of tax that the defendant has evaded, but whether he has willfully attempted to evade the payment or assessment of a tax." *United States v. Miller*, 545 F. 2d 1204, 1214 (9th Cir. 1976). Thus, the defendant's claim that the constructive distribution rules should automatically apply would "nullify all of the taxpayer's prior unlawful acts." *Id.* "To hold otherwise would be to permit the taxpayer to divert such funds and if not caught, to later pay out another return of capital; or, if caught, to avoid conviction by raising the defense that the sums were a return of capital." *United States v. Miller,* 545 F. 2d 1204, 1215 (9th Cir. 1976).

Of course, that is not to say that a defendant can never claim that diverted funds were returns of capital. *United States v. Miller*, 545 F. 2d 1204, 1214 (9th Cir. 1976). However, before the defendant can take advantage of any such claim, he must lay the necessary foundation for their application. *Id.* More specifically, before the constructive distribution rules apply, "there must be some demonstration on the part of the taxpayer and/or the corporation that such

distributions were intended to be [a return of capital]" *United States v. Miller*, 545 F.2d 1204, 1214 (9th Cir. 1976),

Where, however, no such foundation is laid, the constructive distribution rules are irrelevant to the issues in criminal tax prosecutions and do not apply. *United States in Miller*, 545 F. 2d 1204, 1215 (9th Cir. 1976). The Ninth Circuit recently affirmed the holding in *Miller*, in the defendant's appeal of his first trial. *United States in Boulware*, 384 F.3d 794, 810 (9th Cir. 2004). Specifically, the *Boulware* court held that the government can satisfy its burden on both tax evasion and false returns "without proving either that Boulware stole the funds from HIE or that the funds were not loans or *nontaxable returns of capital.*" *United States v. Boulware*, 384 F.3d 794, 810 (9th Cir. 2004).[1]

In the instant matter, it appears that the defendant may contend that some of the diverted funds should be considered constructive distributions or returns of capital. However, there has been no foundation laid for the consideration of such a claim. Indeed, the company controller, Merwyn Manago,

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[1] To the extent that the defendant intends to claim that the government must prove theft or disprove a loan theory in order to prove the defendant guilty of tax evasion and false returns, the government moves to exclude any such line of inquiry or contentions. The Ninth Circuit specifically rejected such a claim in the defendant's appeal of his first trial. *United States v. Boulware*, 384 F.3d 794, 810 (9th Cir. 2004).

testified that during the prosecution years there were no returns of capital. The defendant has offered no evidence to indicate otherwise. Accordingly, absent such foundation, any evidence, testimony and argument relating to the issues of constructive distributions and returns of capital should be excluded.

DATED: June 29, 2005 at Honolulu, Hawaii

Respectfully submitted,

EDWARD H. KUBO
United States Attorney
District of Hawaii

By /s/ Leslie E. Osborne
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Attorney for Defendant
MICHAEL H. BOULWARE

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	CR NO. 99-00239 ER DEFENDANT MICHAEL H. BOULWARE'S PROPOSED SUPPLEMENTAL JURY INSTRUCTIONS; CERTIFICATE OF SERVICE TRIAL DATE: JUNE 27, 2005 TIME: 9:00 A.M. JUDGE: HON. EDWARD RAFEEDIE

DEFENDANT MICHAEL H. BOULWARE'S PROPOSED SUPPLEMENTAL JURY INSTRUCTIONS

(Filed Jun. 20, 2005)

Defendant MICHAEL H. BOULWARE ("BOULWARE"), by and through his attorneys, Reinwald O'Connor and Playdon LLP, pursuant to the Court's order of May 24, 2005, the attached proposed substantive jury instructions.

DATED: Honolulu, Hawaii, June 20, 2005.

/s/ [Illegible]
DENNIS E.W. O'CONNOR
Attorney for Defendant
MICHAEL H. BOULWARE

* * *

DEFENDANT'S PROPOSED
JURY INSTRUCTION NO. 4

The term "taxable income" in federal income law includes the net proceeds (meaning proceeds reduced by allowable deductions) realized from wages, salaries, compensation from professions, vocations, trades, businesses, commerce, rents, royalties, sales or dealings in real or personal properties, interest, dividends, and, in general, immediately enjoyable economic benefits derived from any source whatsoever, in any given taxable year. It does not matter that the income is derived by illegal means as long as the taxpayer does not take possession of property with mutual understanding and acknowledgment with the victim that another is its rightful owner.

Not all money or property that may come into possession of a taxpayer or applied to his use or benefit during a taxable year is taxable income, known as "nontaxable receipts". The proceeds from

loans or funds delivered by a corporation to an employee to be utilized for corporate purposes, called "advances", gifts and inheritances, or money or property that represents the return of funds invested or repayment of loans, or, advances previously made are examples of nontaxable receipts realized by a taxpayer.

A loan occurs when monies are delivered by a person called "lender" to another called a "borrower", pursuant to a verbal or written understanding held by each of the parties that the borrower is required to return the entire sum to the lender at a future time. An advance occurs when funds are delivered by one person "bailor" to another, "bailee", with a verbal or written understanding held by each of them that the funds belong at all times to the bailor and are to be held and utilized by the bailee for the bailor's specified purpose and benefit. If you find that the funds delivered to the Defendant were either loans or advances, you are instructed that the amounts are not taxable income and therefore the Defendant had no duty to report any of such loans or advances as taxable income on his tax returns.

On the other hand, if you find that the monies were not loans or advances and were utilized for the personal benefit of the Defendant, with no intention by the Defendant to repay HIE, then the amounts so expended in each of the respective taxable years are corporate dividends constructively paid to him by HIE but limited to the payments less the returns by the Defendant to HIE during or prior to each of the

taxable years under review. The law provides that dividends are taxable income to a shareholder only if HIE had "earnings and profits", a term which is akin to accumulated corporate profits, first for the taxable year under review, and then from all prior years. Therefore, any dividend distributions in excess of earnings and profits are deemed nontaxable return of the shareholder's investment in his corporate shares, while the balance of the distributions, if any, are taxable income. It is the taxpayer's contention that HIE had no earnings and profits during each of the years under indictment and, furthermore, that the entire amount of distribution did not exceed his investment in the shares of HIE, thereby rendering the entire amount distributed as nontaxable. Accordingly, the Defendant contends that he had no duty to report any of the amounts in question as taxable income on his tax returns.

An important question in this case is whether funds delivered to the Defendant by Hawaiian Isles Enterprises, Inc. ("HIE") and applied for the personal benefit of the Defendant in the annual amounts charged in the indictments were nontaxable receipts such as loans or advances from HIE; or, whether the funds were obtained by the Defendant to principally benefit him and, with the intention never to repay or return the monies to HIE, in which case the funds are taxable to the Defendant as constructive dividends, irrespective of the fact that the transactions are described as loans or advances.

The Government has the burden of proof in establishing every fact that is material and necessary to prove by competent evidence beyond a reasonable doubt that the Defendant realized taxable income and therefore had a duty to report on each of the tax returns in question the respective amounts of additional taxable income asserted in the indictment, but willfully failed to do so. This burden does not at any time or under any circumstance shift from the Government. It is not sufficient for the Government to prove any material fact by suspicion, innuendo, conjecture or by aspersions cast upon the accused by the prosecution. It is not sufficient to establish the existence of unreported taxable income if the evidence presented is evenly divided between taxable and nontaxable income.

U.S. v. Beck, 59-2 USTC (CCH) p9486, *rev'd in part, aff'd in part,* 298 F.2d 622 (9th Cir. 1962); *U.S. v. D'Agostino,* 145 F.3d 69 (2nd Cir. 1998); 26 U.S.C. § 201(c); Action on Decision, CC 1988-025 (Sept. 12, 1988).

GIVEN _____

REFUSED _____

MODIFIED _____

DEFENDANT'S PROPOSED
JURY INSTRUCTION NO.5

Evidence has been introduced to establish that the defendant was a stockholder in Hawaiian Isles

Enterprises, Inc., a corporation, and obtained money from the corporation which the Government contends should have been reported on the defendant's personal tax return.

The defendant has introduced evidence to establish that the money obtained by the defendant from HIE was not income to the defendant but a loan from the corporation or a nontaxable return of the defendant's investment in the corporation or a corporate dividend which was nontaxable because the corporation had no earnings and profits for the years in question.

In determining whether the defendant received any income from his corporation, you are instructed as follows:

1. Dividend. A distribution by a corporation to or for the benefit of a stockholder that is not a loan is reportable as a dividend to the extent that the distribution (or any part thereof) could have been paid out of the accumulated earnings and profits of the corporation; or out of the earnings and profits of the corporation for the taxable year in issue.

2. Return of Capital. If the accumulated and current earnings and profits of the corporation are not great enough in amount to account for all, or a part of, the distribution to the defendant, then that portion of the distribution which could not be paid out of earnings and profits would be a nontaxable return of capital up to the amount of money invested in the corporation by the defendant.

3. Capital Gain Income. Finally, any portion of the distribution which exceeds both the accumulated earnings and profits of the corporation and the amount the defendant had invested in the corporation, would be capital gain income to the defendant.

4. Loan. If you find that a distribution received by the defendant (or any part thereof) was a loan from the corporation, which was repaid or to be repaid, then to the extent that the distribution was a loan, it would not be income to the defendant.

Department of Justice Criminal Tax Manual Model Jury Instructions No. 302.

GIVEN _____

REFUSED _____

MODIFIED _____

* * *

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UNITED STATES OF AMERICA

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	CR. NO. 99-00239 ER UNITED STATES' OBJECTIONS TO DEFENDANT'S PROPOSED SUPPLEMENTAL JURY INSTRUCTIONS; CERTIFICATE OF SERVICE Trial Date: June 27, 2005 Time: 9:00 a.m. Judge: Hon. Edward Rafeedie

UNITED STATES' OBJECTIONS TO DEFENDANT'S PROPOSED SUPPLEMENTAL JURY INSTRUCTIONS

(Filed Jun. 23, 2005)

COMES NOW, the United States of America, by and through its undersigned attorneys, and submits its objections to defendant's proposed supplemental jury instructions dated June 20, 2005. As directed by this Honorable Court, all objections are set forth within; and the proposed instruction is set forth

* * *

(1976). Accordingly, the defendant's proposed instruction confuses the issue.

UNITED STATES ALTERNATIVE JURY INSTRUCTION:

Willfulness as used in these instructions requires the government to prove that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty.

DEFENDANT'S PROPOSED SUPPLEMENTAL JURY INSTRUCTION NO. 4

The term "taxable income" in federal income tax law includes the net proceeds (meaning proceeds reduced by allowable deductions) realized from wages, salaries, compensation from professions, vocations, trades, businesses, commerce, rents, royalties, sales or

dealings in real or personal properties, interest, dividends, and, in general, immediately enjoyable economic benefits derived from any source whatsoever, in any given taxable year. It does not matter that the income is derived by illegal means as long as the taxpayer does not take possession of property with mutual understanding and acknowledgment with the victim that another is its rightful owner.

Not all money or property that may come into possession of a taxpayer or applied to his use or benefit during a taxable year is taxable income, known as "nontaxable receipts". The proceeds from loans or funds delivered by a corporation to an employee to be utilized for corporate purposes, called "advances", gifts and inheritances, or money or property that represents the return of funds invested or repayment of loans, or, advances previously made are examples of nontaxable receipts realized by a taxpayer.

A loan occurs when monies are delivered by a person called "lender" to another called a "borrower", pursuant to a verbal or written understanding held by each of the parties that the borrower is required to return the entire sum to the lender at a future time. An advance occurs when funds are delivered by one person "bailor" to another, "bailee", with a verbal or written understanding held by each of them that the funds belong at all times to the bailor and are to be held and utilized by the bailee for the bailor's specified purpose and benefit. If you find that the funds delivered to the Defendant were either loans or

advances, you are instructed that the amounts are not taxable income and therefore the Defendant had no duty to report any of such loans or advances as taxable income on his tax returns.

On the other hand, if you find that the monies were not loans or advances and were utilized for the personal benefit of the Defendant, with no intention by the Defendant to repay HIE, then the amounts so expended in each of the respective taxable years are corporate dividends constructively paid to him by HIE but limited to the payments less the returns by the Defendant to HIE during or prior to each of the taxable years under review. The law provides that dividends are taxable income to a shareholder only if HIE had "earnings and profits", a term which is akin to accumulated corporate profits; first for the taxable year under review, and then from all prior years. Therefore, any dividend distributions in excess of earnings and profits are deemed nontaxable return of the shareholder's investment in his corporate shares, while the balance of the distributions, if any, are taxable income. It is the taxpayer's contention that HIE had no earnings and profits during each of the years under indictment and, furthermore, that the entire amount of distribution did not exceed his investment in the shares of HIE, thereby rendering the entire amount distributed as nontaxable. Accordingly, the Defendant contends that he had no duty to report any of the amounts in question as taxable income on his tax returns.

An important question in this case is whether funds delivered to the Defendant by Hawaiian Isles Enterprises, Inc. ("HIE") and applied for the personal benefit of the Defendant in the annual amounts charged in the indictments were nontaxable receipts such as loans or advances from HIE; or, whether the funds were obtained by the Defendant to principally benefit him and, with the intention never to repay or return the monies to HIE, in which case the funds are taxable to the Defendant as constructive dividends, irrespective of the fact that the transactions are described as loans or advances.

The Government has the burden of proof in establishing every fact that is material and necessary to prove by competent evidence beyond a reasonable doubt that the Defendant realized taxable income and therefore had a duty to report on each of the tax returns in question the respective amounts of additional taxable income asserted in the indictment, but willfully failed to do so. This burden does not at any time or under any circumstance shift from the Government.

It is not sufficient for the Government to prove any material fact by suspicion, innuendo, conjecture or by aspersions cast upon the accused by the prosecution. It is not sufficient to establish the existence of unreported taxable income if the evidence presented is evenly divided between taxable and nontaxable income.

UNITED STATES'
OBJECTION TO INSTRUCTION NO. 2:

The defendant's definition of income is too long and complex and, at this time, unsupported by the evidence. For example, with regard to the portion of the instruction indicating that neither a gift or inheritance is income, there is no evidence whatsoever indicating that any of the charged income could be a gift or an inheritance.

Additionally, with regard to the issue of constructive dividends, the Ninth Circuit requires that "there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be [a return of capital]" *United States v. Miller,* 545 F.2d 1204, 1214-15 (9th Cir. 1976), before a constructive dividend instruction should be given. In this case, there is no indication that there was either a dividend or a return of capitol.

Further, to the extent that a loan instruction is warranted, it should be given, as proposed by the government, in a separate instruction with the applicable law for determining whether there is indeed a loan in existence.

UNITED STATES
ALTERNATIVE JURY INSTRUCTION:

The term gross income for income tax purposes consists of income from whatever source derived, including but not limited to compensation for services.

The term taxable income means gross income minus any deductions allowed by law.

When monies are acquired, lawfully or unlawfully, without consensual recognition of an obligation to repay or restriction on their disposition, such monies are income even though it may still be claimed that the defendant is not entitled to retain the money and even though he may be required to restore its equivalent.

A true loan is not income. *James v. United States,* 366 U.S. 213, 219-20. A true loan is an agreement, either express or implied, whereby one party advances money to the other and the other agrees to repay it upon such terms as to time and rate of interest, or without interest, as the parties may agree. *Welch v. Commissioner of Internal Revenue Service,* 204 F.3d 1228, 1230 (9th Cir. 2000). Alternatively, an alleged loan unaccompanied by a contemporaneous intent to repay, is income in the year in which it was received. *James v. United States,* 366 U.S. 213, 219.

In determining whether a true loan exists, although not exclusive, the following factors are relevant: (1) whether the promise to repay is evidenced by a note or other instrument; (2) whether interest was charged; (3) whether a fixed schedule of repayments was established; (4) whether collateral was given to secure payment; (5) whether repayments were made; (6) whether the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and

(7) whether the parties conducted themselves as if the transaction were a loan. *Welch v. Commissioner of Internal Revenue Service,* 204 F.3d 1228, 1230 (9th Cir. 2000).

DEFENDANT'S PROPOSED
SUPPLEMENTAL JURY INSTRUCTION NO. 5

Evidence has been introduced to establish that the defendant was a stockholder in Hawaiian Isles Enterprises, Inc., a corporation, and obtained money from the corporation which the Government contends should have been reported on the defendant's personal tax return.

The defendant has introduced evidence to establish that the money obtained by the defendant from HIE was not income to the defendant but a loan from the corporation or a nontaxable return of the defendant's investment in the corporation or a corporate dividend which was nontaxable because the corporation had no earnings and profits for the years in question.

In determining whether the defendant received any income from his corporation, you are instructed as follows:

1. Dividend. A distribution by a corporation to or for the benefit of a stockholder that is not a loan is reportable as a dividend to the extent that the distribution (or any part thereof) could have been paid out

of the accumulated earnings and profits of the corporation; or out of the earnings and profits of the corporation for the taxable year in issue.

2. Return of Capital. If the accumulated and current earnings and profits of the corporation are not great enough in amount to account for all, or a part of, the distribution to the defendant, then that portion of the distribution which could not be paid out of earnings and profits would be a nontaxable return of capital up to the amount of money invested in the corporation by the defendant.

3. Capital Gain Income. Finally, any portion of the distribution which exceeds both the accumulated earnings and profits of the corporation and the amount the defendant had invested in the corporation, would be capital gain income to the defendant.

4. Loan. If you find that a distribution received by the defendant (or any part thereof) was a loan from the corporation, which was repaid or to be repaid, then to the extent that the distribution was a loan, it would not be income to the defendant.

UNITED STATES'
OBJECTION TO INSTRUCTION NO. 5:

As stated previously, with regard to the issue of constructive dividends, the Ninth Circuit requires that "there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be [a return of capital]" *United*

States v. Miller, 545 F.2d 1204, 1214-15 (9th Cir. 1976), before a constructive dividend instruction should be given. The rational behind such a rule is straightforward: Tax evaders should not escape criminal liability simply because the intricacies of the tax law result in no tax due and owing. *United States v. Miller,* 545 F.2d 1204, 1214-15 (9th Cir. 1976). In this case, there is no indication that there was either a dividend or a return of capitol. Accordingly, there should be no instruction with regard to constructive dividends.

UNITED STATES
ALTERNATIVE JURY INSTRUCTION:

The government has no alternative instruction because this instruction should not be given.

* * *

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA,	)	
Plaintiff,	)	CRIMINAL NO. 99-00239ER
vs.	)	
MICHAEL H. BOULWARE,	)	– VOLUME 2 –
Defendant.	)	

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Tuesday, June 28, 2005, at 9:15 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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Attorneys for the Defendant

* * *

[161] BY MR. O'CONNOR:

Q. In any event, from the standpoint of the corporate books, all the tax problems had been taken care of by you; is that right?

A. By the pickup of the income –

Q. Yes.

A. – the over-reporting of the income?

Q. Yes.

A. Uh-huh.

Q. Okay.

Now let's shift to Mike Boulware.

You've done Mike Boulware's personal taxes for many years now; is that right?

A. That's right.

Q. In the time that you have done Mike Boulware's personal taxes, has the company, HIE, had earnings and profits, in a general sense?

A. No.

Q. In doing Mike Boulware's taxes, did you – you knew, in each year, that the company had no earnings and profits; is that right?

MR. DWYER: Objection, Your Honor. Relevance?

THE COURT: Overruled.

BY MR. O'CONNOR:

Q. Have you been called upon to render an opinion, in any [16] regard, regarding Mike Boulware's income and its relationship to the earnings and profits of the company?

A. No.

Q. When should tobacco taxes be picked up as income if they are overpaid?

A. If they are overpaid?

MR. DWYER: Objection, Your Honor; vague. I think there's federal taxes, I think there's state –

THE COURT: Do you understand the question?

THE WITNESS: I don't really –

THE COURT: Restat your question.

MR. O'CONNOR: Yes.

BY MR. O'CONNOR:

Q. In this situation, HIE is in the tobacco business, right?

A. Yes.

Q. They sell a large amount of tobacco every year; is that correct?

A. That's correct.

Q. For the tobacco that HIE sells every year, state taxes must be paid on that tobacco sale, right?

A. Exactly.

Q. Are you familiar with the fact that HIE at some point realized that they had been paying taxes at the wrong time on tobacco taxes?

A. Yeah. I'm not – I'm not – yes, I do, in concept. I

* * *

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff,	) CRIMINAL NO. 99-00239ER
vs.	)
MICHAEL H. BOULWARE, Defendant.	) - VOLUME 3 -

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Wednesday, June 29, 2005, at 9:03 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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Attorneys for the Defendant

* * *

[138] All rise.

This court will be in recess for a short recess.

(A recess was taken from 1:57 to 2:02 p.m.)

(The following proceedings were held in open court, in the presence of the jury:)

(Mr. Manago resumed the witness stand.)

THE COURT: All right, continue your examination of this witness.

BY MR. OSBORNE:

Q. Mr. Manago, the capital account is where contributions from the shareholders went. Do you agree with that?

A. Yes.

Q. With that understanding, was there any return to shareholders out of the capital account during the years '89 through '97?

A. No.

Q. And, about these lease payments, were any entries made in the loans to shareholders to compensate for these lease payments?

A. Yes.

Q. What was done to the loans to shareholders?

A. We reversed the rental expense, and charged the officer loan account.

Q. When did you do that?

Let me be more direct: Was that part of the

* * *

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA,	)	
Plaintiff,	)	CRIMINAL NO. 99-00239ER.
vs.	)	
MICHAEL H. BOULWARE,	)	– VOLUME 4 –
Defendant.	)	

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Thursday, June 30, 2005, at 9:15 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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* * *

[109] THE COURT: Well, that's all only relevant if he overlooked something by not following the lead.

But you may step down, ma'am.

MR. OSBORNE: Your Honor, on another matter, just to make a record:

Could I just put on the record, Your Honor, that there was an objection by the defense which the court overruled as to Exhibits 700 through 711.

I had failed to say at the time I offered them they are offered pursuant to Rule 1006.

THE COURT: Well –

MR. OSBORNE: I'm sure the court knew that.

THE COURT: – I assumed that.

MR. OSBORNE: Okay.

THE COURT: I want to rule on this motion, because I think it will relieve – or move things along.

The government has filed a motion in limine to exclude evidence that Hawaiian Island Enterprises over-reported its income, claiming that it is irrelevant because Hawaiian Island Enterprises and Boulware were separate taxpayers.

The defendant has filed an opposition, in which he raises two separate arguments:

First, the defendant argues that Boulware was authorized by Hawaiian Islands' board of directors to expend [110] the funds at issue in furtherance of corporate objectives.

The thrust of this argument seems to be that the money was never income to Boulware; it was the property of the corporation.

However, even if true, the court does not see how this argument is relevant to Hawaiian Island Enterprises' over-reporting of income.

The issue of whether Hawaiian Island Enterprises over-reported its income is completely independent to the issue of Boulware's authorization to expend money on behalf of the corporation.

Second, the defendant argues that Hawaiian Island Enterprises' income is relevant because it determines whether a corporate distribution to Boulware was out of its earnings and profits, and hence, a taxable dividend, or simply a non-taxable return of capital.

The Ninth Circuit, however, explicitly rejected this argument in Boulware's appeal, in United States versus Boulware. In that case, the court stated regarding an argument of insufficiency of the evidence, quote:

"The sufficiency of the evidence issue boils down to whether the government could have proved the elements of Section 7206-1 and 7201 beyond a reasonable doubt without proving either that Boulware stole the funds from Hawaiian Island Enterprises or that funds were not loans or non-taxable [111] returns of capital."

They continued:

"United States versus Miller, 545 F.2d, 1204, Ninth Circuit, 1976, indicates that the answer to this question is yes.

"Because the government could prove the elements of proof beyond a reasonable doubt without showing that the funds were a non-taxable return of capital, Hawaiian Islands Enterprises' over-reporting of income is simply irrelevant."

Therefore, the motion to exclude this evidence of alleged over-reporting of income is granted.

MR. KANESHIRO: Your Honor, may I be heard on that?

THE COURT: Yes, you may.

MR. KANESHIRO: First of all, as to the one part – Mr. Yamachika just testified –

THE COURT: Come up here.

MR. KANESHIRO: Oh, I'm sorry (approaching podium). Sorry, Your Honor.

Mr. Yamachika's just testified that, based on his bank deposit method, he traced or he looked at certain funds that went into two bank accounts that he claims or that the government is contending was never reported by the corporation, never recognized by the corporation as income. To that point, the over-reporting of income for those years is part of our defense that, in fact the [112] corporation did recognize it.

The fact that Mr. Manago may not have consciously known what the income was doesn't necessarily mean that the corporation did not report the income.

Because Mr. Boulware understood and told Mr. Manago to book certain income. So that's part of the defense of establishing –

THE COURT: Well, you've got to present these defenses. They can't be inferred. You haven't presented any defense yet.

MR. KANESHIRO: Well, that's the point. If you are going to do a motion in limine right now, you prevent us from doing it in our defense.

THE COURT: Well, a motion in limine means that during the prosecution's case, you should not be allowed to go into this.

Now, that may change depending on what evidence you present.

MR. KANESHIRO: I see. So the motion in limine –

THE COURT: You are entitled to explain what the government is relying upon here to convict your client. If you have explanations that can be given through competent witnesses, they may be presented.

But it seems to me that that issue of –

You see, in other words, you're entitled to present [113] this kind of defense if you think you can; that is, if it was a – if there was really anybody followed it at that time.

If it's merely an attempt to explain away what has happened by something that really didn't happen, then it's a phony defense.

MR. KANESHIRO: But, Your Honor, as I understand it, the court is looking at this motion in limine only as to the evidence being brought in the prosecution's case.

THE COURT: Well, no, that's not true. I'm saying this is not relevant, in the view of the court, and I have granted their motion to exclude it.

Now, if the posture of the evidence changes, for example, if we had evidence that the board of directors met and made a decision that this was to be treated in this way and that this money was to be

treated as non-taxable returns of capital, that's fine; you can present that kind of evidence.

MR. KANESHIRO: Your Honor, that evidence is already in front of the jury.

THE COURT: The government's case is in front of the jury; yours isn't.

MR. KANESHIRO: So I just want to make clear that we may be able to produce this type of evidence in our case; we are not foreclosed from doing that?

MR. KANESHIRO: Look, I'm not going to tell you how [114] to put on a defense.

But my ruling now is that this evidence is irrelevant.

MR. KANESHIRO: On the state of the evidence as it now stands?

THE COURT: Well, it's irrelevant for the reasons that I stated: That the government can prove these charges without the need to show this –

Once they have proved a prime facie case, what they think is a prima facie case of unreported income, then the defendant has the opportunity to respond to it and to present evidence to explain it away.

MR. KANESHIRO: But at this point, as I understand the court's ruling, we can't even put on that evidence.

THE COURT: The ruling stands. Unless the court makes a further ruling.

So there is to be no such evidence without further order from the court.

MR. KANESHIRO: Your Honor, as I understand it, the ruling in the Boulware case, the court only said that, as far as the sufficiency of the evidence was concerned, this may not be part of it.

But that's only as to the government's prima facie case. It says nothing about our defense.

THE COURT: Your problem is that you have been [115] trying to prove your defense through the government's witnesses. I suggest you prove it through your own witnesses.

MR. KANESHIRO: I just want to make clear that –

THE COURT: That works much better.

MR. KANESHIRO: – in our part of the case, we are not foreclosed from going into this evidence.

THE COURT: You don't have to put on any case at all if you don't want to.

MR. KANESHIRO: I understand that.

THE COURT: You understand that.

MR. KANESHIRO: But I just want to make clear that this order does not foreclose us from putting on such evidence in our case.

THE COURT: It does foreclose you unless there is a further order to the contrary.

So you can't put it on without first giving the court – making a request to the court to put it on, and explaining why this order should not be in effect for some kind of evidence that you intend to present.

That's all, counsel.

MR. KANESHIRO: Thank you, Your Honor.

THE CLERK: All rise.

Court will be in recess until 1:30 p.m.

(The lunch recess was taken at 12:12 p.m.)

* * *

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Attorney for Defendant
MICHAEL H. BOULWARE

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	CR NO. 99-00239 ER MEMORANDUM IN OPPOSITION TO MOTION IN LIMINE TO PRECLUDE DEFENDANT FROM INTRODUCING EVIDENCE, TESTIMONY AND ARGUMENT RELATING TO THE ISSUES OF CONSTRUCTIVE DIVIDENDS AND RETURNS OF CAPITAL FILED ON JUNE 30, 2005; CERTIFICATE OF SERVICE HEARING DATE: TIME: JUDGE: EDWARD RAFEEDIE TRIAL DATE: JUNE 27, 2005

MEMORANDUM IN OPPOSITION TO MOTION IN LIMINE TO PRECLUDE DEFENDANT FROM INTRODUCING EVIDENCE, TESTIMONY AND ARGUMENT RELATING TO THE ISSUES OF CONSTRUCTIVE DIVIDENDS AND RETURNS ON CAPITAL FILED ON JUNE 30, 2005

(Filed Jul. 01, 2005)

Relying upon a misreading of *U.S. v. Miller,* 545 F.2d 1204 (9th Cir. 1976) and *U.S. v. Boulware,* 384 F.3d 794 (9th Cir. 2004), the government moves this Court *in limine* to preclude the introduction or argument of evidence concerning constructive dividends and returns of capital. The government erroneously argues that *Miller* and *Boulware* foreclose Defendant Michael H. Boulware from arguing that the allegedly diverted funds constitute a constructive dividend or a return of capital. More specifically, the government argues that since *Miller* and *Boulware* hold that the government only needs to prove the taxpayer assumed control of funds and a failure to report said funds to show tax evasion under the statutes, evidence of constructive dividend or return of capital is irrelevant.

However, the government misconstrues, misapplies and misstates the holdings of *Miller* and *Boulware.* In particular, the Ninth Circuit in *Miller* noted that introduction of such evidence is on a case by case basis. In *Miller,* the Ninth Circuit plainly concluded "that whether diverted funds constitute constructive

corporate distributions depends on the factual circumstances involved in each case under consideration." 545 F.2d 1214-15.

> The Ninth Circuit further explained in *Miller* that
>
> [i]n holding that the constructive distribution rules should not automatically be applied, it is not herein asserted that diverted funds could never be a return of capital. However, to constitute the latter, there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return.

Id. at 1215.

Thus, the Ninth Circuit made clear in *Miller* that whether allegedly diverted funds constitute constructive corporate distributions must be decided on a case-by-case basis with "some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be such a return." Defendant Boulware will present evidence that the allegedly diverted funds were HIE monies used by Defendant Boulware for corporate purposes and that such use of the funds by Mr. Boulware was recognized and approved by HIE as established by the government's own exhibits in evidence, Exhibits 63A and 63B. Those exhibits prove that in 1990 and 1991, before the IRS began its investigation of Defendant Boulware, the directors of HIE had already authorized its President, Defendant Boulware, "to use funds of the Corporation for the purpose of establishing new

business ventures for the Corporation and will account four such funds as an advance, including actions to establish the coffee and real estate business to be accounted for once established and turned over to the company." Government's Exhibit 63B. Thus, according to *Miller*, the question of whether the allegedly diverted funds may be treated as constructive corporate dividends or return of capital is a factual issue for the jury that Defendant Boulware is entitled to develop in his case-in-chief.

In *Boulware,* the Ninth Circuit never ruled that the characterization of the allegedly diverted funds as constructive dividends or return of capital or corporate loans was irrelevant. Instead, the Ninth Circuit, in determining whether the government had met its prima facie burden, concluded that the government was not required to prove that the allegedly diverted funds were not loans. The Ninth Circuit, citing *Miller,* noted that "the defendant had the burden of going forward once the government 'demonstrates that the taxpayer had unexplained funds which *could be considered* as income which the taxpayer fails to report in his return.'" 384 F.3d at 811.

In other words, the Ninth Circuit placed the burden of proving the characterization of the allegedly diverted funds upon the defendant. The Ninth Circuit did not, as the government contends, rule that the characterization of funds as constructive dividends or return of capital or corporate loans was irrelevant. It merely shifted that burden the defendant once the government established its prima facie case.

It is also important to note that in the *Miller,* the Ninth Circuit concluded that the defendant was factually precluded from arguing that the moneys were constructive dividends because the defendant Miller admitted that he was not a shareholder of the subject corporation. Therefore, the Ninth Circuit concluded that the corporate distribution rules could not apply to him because "the only capacity in which Miller was entitled to receive the diverted funds was as an employee-officer of the corporation." 545 F.2d at 1215.

Here, it is undisputed that at all times relevant, Boulware was a shareholder of HIE and therefore, could be entitled to received funds from HIE as a corporation distribution. In *Davis v. United States,* 226 F.2d 331 (6th Cir. 1955) the Sixth Circuit Court noted that "money received by a corporation was not income to an individual unless the corporation funds were in some way transferred or diverted to the individual, and became property over which he exercised dominion and control and treated as his own, to ***the exclusion of any interest therein by the corporation***. . . ." Id. at 334; emphasis added. In *Miller* the allegedly diverted funds "were not recorded as sales on the corporate books, or reported in the corporate tax returns" nor were they reported as income by the individual taxpayer. In other words, neither the corporation nor the individual shareholder reported the income. Therefore, the issue before the Ninth Circuit was who should have reported the income.

In the present case, however, Defendant Boulware will prove that HIE reported the allegedly diverted funds as income on its corporate tax returns. Mr. Boulware will also prove that there was corporate recognition that he would be using corporate funds to develop various business ventures. Therefore, it is Defendant Boulware's position that whether the corporate funds he used could be characterized as constructive dividends, return of capital, corporate loans or corporate advances is a question of fact for the jury to decide as a part of his defense to the charged crimes.

The government's reliance on *Miller* is also misplaced because *Miller* was decided prior to the tax court opinion in *Truesdale v. Comm.*, 89 T.C. 1280 (1987) and prior to the IRS's Action on Decision 1988-025 in which the IRS agreed with the reasoning of the Tax Court in *Truesdale.* After the *Truesdale* decision, the IRS changed its policy to reflect a "no earnings and profits, no income" approach that markedly differs from *Miller.* In 1988, the Tax Litigation Division of the Internal Revenue Service issued an Action on Decision that stated:

> Funds diverted to the shareholder of a wholly owned corporation should be regarded as constructive distributions, unless the funds were additional salary or otherwise were received in a nonshareholder capacity. The funds should be included in the income of the corporation and taxed to the shareholder in accordance with I.R.C. [§] 301(c).

> *When such funds are received in a shareholder capacity, we will no longer argue they are ordinary income regardless of earnings and profits.* (emphasis added).

Action on Decision, CC-1988-025, 1988 AOD Lexis 22.

Under the "no earnings and profits, no income" rule, diverted corporate funds are treated as a constructive dividend to the shareholder to the extent the corporation had earnings and profits. To the extent that a corporation's distribution to a shareholder is *not* made out of earnings and profits, I.R.C. § 301(c)(2) treats the distribution as a return of capital to the shareholder that is applied against and made in reduction of the adjusted basis of the shareholder's stock; or, if applicable, the distribution is treated as a return of a loan.

It is axiomatic that criminal tax law must follow civil tax liability. Otherwise, it would lead to the absurd result that a taxpayer could be found criminally liable based on his tax return for a particular year when the same return would be acceptable under the prevailing interpretation of civil tax law. Yet that would be the case if this Court applies *Miller* with the broad brush that the Government suggests without distinguishing its facts and recognizing the interpretation given the tax code in the civil enforcement context by the Tax Court and the IRS in decisions reported after *Miller.*

More recent decisions from other jurisdictions have so recognized. In *U.S. v. D'Agostino,* 145 F.3d 69

(2nd Cir. 1998), the Second Circuit explained as follows:

> In *Williams,* the Eleventh Circuit held that, in criminal tax evasion cases, the government is not required to characterize diverted income and therefore need not prove that diverted Finds constitute a constructive dividend or that the corporation had any earnings and profits. *Id.* at 851-52. Instead, the government need only show the taxpayer had actual command over the funds. *Id.* at 850 (quoting *Davis v. United States,* 226 F.2d 331, 335-36 (6th Cir. 1955), cert. denied, 350 U.S. 965, 73 S.Ct. 432 (1956)). We decline to adopt this approach. . . . Furthermore, we believe the rule of this Circuit is better reasoned. The *Williams* rule purports to minimize the government's burden of proving a tax deficit and places greater emphasis on the intent element in criminal tax evasion cases. **The apparent result,** however, is that the **government bears a higher burden of proof in a civil tax collection matter than in a criminal tax evasion prosecution.** In addition, the approach taken in *Williams* and *Davis* **effectively eliminates proof of a tax deficiency as an element of a 26 U.S.C. § 7201 violation.** Under the *Williams* rule, the government would only need to prove that the taxpayer willfully intended to exercise domain and control over the diverted funds and took affirmative acts to evade paying taxes. **If Congress intended this showing to**

> **suffice to establish a violation of § 7201, it would not have included a tax deficit as a requisite element.**
>
> We have little doubt the D'Agostinos acted with bad intentions. Anne Marie hid, in total, $400,000 in large bills in her kitchen drawers and failed to reflect the diverted corporate funds in Koin Key's corporate books. It is entirely possible the D'Agostinos intended to evade paying taxes on the diverted funds. However, bad intentions, alone, are not punishable. **The diversion of the funds cannot constitute a criminal offense, despite criminal intent, if no taxes are due.**

Id. at 73.

Moreover, when the government seeks to rely on a taxpayer's control of funds to prove that the taxpayer has received taxable income, **"[s]uch control must be to the exclusion of any of the rights in the money asserted by the corporation."** *United States v. Toushin,* 899 F.2d 617, 622 (7th Cir. 1990). The owner of a wholly owned business may "take the money for a number of legitimate reasons," as the government itself argued in *Toushin. Id.* at 622.[1]

Finally, the government claims that no foundation has been laid pursuant to *Miller* for introduction of evidence pertaining to the defenses of constructive dividends or return of capital. However, the government just rested its case-in-chief and Defendant Boulware has not as yet been given the opportunity

to present its defense case. Therefore, for the Court to preemptively preclude Defendant Boulware from laying the very foundation that the government argues is lacking would be highly prejudicial and premature.

Neither *Miller* nor *Boulware* holds that a corporate dividend or return of capital defense is never relevant to a tax evasion charge. In fact, *Miller* makes clear that the contrary is true; i.e., "that whether diverted funds constitute constructive corporate distributions depends on the factual circumstances involved in each case under consideration." 545 F.2d 1214-15.

For the foregoing reasons, Defendant Boulware respectfully submits that the government's motion must be denied.

DATED: Honolulu, Hawaii, July 1, 2005.

/s/ [Illegible]
DENNIS E. W. O'CONNOR
Attorney for Defendant
MICHAEL H. BOULWARE

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	)	CRIMINAL NO. 99-00239ER - VOLUME 5 -

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Friday, July 1, 2005, at 9:11 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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* * *

[6] second year of leave. And then I resigned, formally, in '89.

Q. At that time what was Michael's position? Michael, your brother.

A. He was the president and owner of the company.

Q. Had he established the company?

A. Yes.

Q. And, in establishing the company – well, what did this company start as?

A. The company started primarily in 1981, heavily into the video games. Slowly, after that –

THE COURT: The question was when, and you've answered that.

BY MR. O'CONNOR:

Q. When the company started, how many employees did it have?

A. Two, three, four.

Q. And where was it located?

A. Either on – originally, I believe it was in the back room on Kapiolani Boulevard.

Q. How many employees does the company have today?

A. Over 220.

Q. And where are you located today?

A. On every island: Maui, Kauai, the Big Island, and Oahu.

Q. Is your home office on Oahu?

A. Yes.

Q. And where is that?

* * *

[17] Q. Now, Mr. Manago has testified in this courtroom that there were certain bank accounts that were operated by Michael that Manago had no knowledge of.

If Manago did not know about a bank account, does that indicate that no one in the corporation knew about it?

A. Could you say that again?

Q. Yeah.

Does Manago's lack of knowledge of a bank account –

MR. DWYER: Objection, Your Honor; calls for speculation.

THE COURT: Sustained.

BY MR. O'CONNOR:

Q. Did you have a rather firm knowledge, in the years 1992 through today, of the financial situations of the company?

A. Yes.

Q. And did you follow it on a regular basis?

A. Yes.

Q. Did you know that Mike Boulware was – your brother – was spending company money for various things like we just talked about, the coffee buying, but other things, too?

A. Probably. I can't remember.

Q. Well, there came a time, for example, when you established a water company; is that right?

A. Yes.

Q. And that water company bottles and sells Hawaiian water; [18] is that correct?

A. Yes.

Q. You can find these in almost every supermarket in Honolulu, right?

A. Throughout the state.

Q. And on the mainland, too?

A. Very sporadic on the mainland.

Q. How about the commissaries?

A. Only in the state of Hawaii.

Q. Okay.

But you can find these bottled water from Hawaiian Isles in quite a few places; is that right?

A. Yes.

Q. Is that a growing business today?

A. Yes.

Q. Was that business established by Mike Boulware?

A. Yes.

Q. After he established the business –

MR. O'CONNOR: Well, strike that.

BY MR. O'CONNOR:

Q. In establishing the business, do you know where Mike got the money to build the plant and get the business going?

A. From the company. I'm not sure.

Q. You say from the company. Do you know how the company got the money to Mike?

[19] A. Could be officer loans.

Q. Was there a time when Mike turned that business, the water business, back to the company?

A. Yes.

Q. When he turned it back to the company, was any money paid to Mike?

A. No.

Q. We were talking a little bit about the Kona coffee business.

Did Mike eventually put together a wholesaling operation for purchase of Kona coffee in Kona?

A. I'm not sure.

Q. Who would know that? Mike?

A. Well, he should.

THE COURT: That's rather difficult for this witness to answer who would know that.

MR. O'CONNOR: You're right, Your Honor, obviously.

BY MR. O'CONNOR:

Q. But such a business does exist, does it not, the business for the acquisition of Kona coffee in Kona?

A. Are we talking about current? Or previous?

Q. Both.

A. Yes, there is.

Q. And do you folks get your coffee through that system?

A. Yes.

[20] Q. And did Mike put it together?

A. Yes.

Q. Did there come a time when Mike turned that business, if you will, back to the company?

A. Yes.

Q. Did he get paid any money for that?

A. Not that I know of.

Q. Where did the money come from for Mike to establish that business?

A. The company.

Q. Okay.

Do you know Mal Sun Boulware?

A. Yes.

Q. Who is that?

A. It was Michael's former wife.

Q. Are they now divorced?

A. Yes.

Q. Was that a pleasant divorce or a difficult divorce, from your observation?

A. I think it was a costly divorce.

Q. Costly to whom?

A. Michael.

Q. Did the company also have to come up with some money regarding that?

A. I know it cost the company money, yes.

* * *

[38] A. Not to my knowledge.

Q. So, when you say that she was going to get part of the company as part of the divorce, really Mike had all the stock in the company, right? You owned some.

A. I believe he had all the stock.

Q. Okay.

And so the only interest that she was going to get was whatever property Mike had, correct?

I mean, she couldn't go to the company and say I want some of – 50 percent of the company?

A. I'm under the assumption that, because of their marriage, she's entitled to 50 percent of –

Q. His property.

A. – whatever's been accumulated.

Q. Which would be the stock in the company, correct? Mike's property.

MR. O'CONNOR: I object, Your Honor.

THE COURT: Well, we are getting into legal questions here –

THE WITNESS: I'm not a lawyer.

THE COURT: – of what she's entitled to.

This witness should be asked about his knowledge of those things, if any.

MR. DWYER: Sure.

BY MR. DWYER:

* * *

[65] THE COURT: Well, are you trying to qualify this witness as an expert witness?

MR. O'CONNOR: I'm just trying to show his background, Your Honor, so I can ask him a question about divorce work.

THE COURT: Well, I think the objection is sustained.

You can ask him about his own background –

MR. O'CONNOR: I will do that.

THE COURT: – he already testified to that.

BY MR. O'CONNOR:

Q. In the work that you've done in divorces, have you been required to handle property divisions?

A. I've never seen a divorce without a property division, in the hundred or so that I've handled.

Q. Are you familiar with the law of Hawaii as it involves property divisions between divorcing wives – or divorcing spouses?

A. I feel I'm quite familiar with what the law has been and what it currently is.

Q. Were you the attorney for Michael Boulware in the scope of his divorce from Mal Sun Boulware?

A. Yes, I was.

Q. Was there property involved in that divorce?

A. Quite a substantial amount of property.

[66] Q. And do you remember what the property was?

A. I do.

Q. What was the property involved?

A. The property basically consisted of two assets: One was a house that the two of them had lived in; and the other was Hawaiian Isles Enterprises, an ongoing business. That was one of the major, major assets that had to be looked at to determine who was going to get what.

Q. Did the wife, Mal Sun Boulware, have a claim in the divorce action as to Hawaiian Isles Enterprises?

MR. OSBORNE: Objection; leading.

THE COURT: Overruled.

A. There was absolutely no doubt in my mind that she had, by way of a –

THE COURT: Well, the question was –

THE WITNESS: Yes.

THE COURT: – did she make a claim in that case.

THE WITNESS: Yes, she did.

THE COURT: All right.

BY MR. O'CONNOR:

Q. And was that part of the divorce debate between husband and wife in that case?

A. Yes, it was.

Q. Was it required that a value be established for the company?

* * *

[71] Isles?

A. In the neighborhood of $3.5 to $3.6 million, from what I can recall.

Q. Now, that $3.5 to $3.6 million, why was that attributed to her? Why did she have that interest in Hawaiian Isles?

A. I originally explained to the client Mike, that in a long-term marriage, in the state of Hawaii, from my experience in the law, that whatever the spouses accumulate together during the term of the marriage, each has an interest – a marital interest in that asset.

And since Hawaiian Isles Enterprises became a success during the term of their marriage, and had become quite successful as far as an operating company, then she would have – whether the stock was in her name or not – she would have a one-half interest, equitable interest, however you want to term it, a one-half interest in that company.

Q. Now, there was no stock in her name; is that correct?

A. There was none.

Q. So she held this interest because she was his wife at the time the company was formed and progressed; is that correct?

A. That's correct.

Q. Was this agreement included in the decree?

A. Yes, it was. I believe by reference as to its date and things of that nature. But it was part of the decree.

Q. The $3.6 million, was that broken out into a payment [72] schedule of some sort?

A. I know there's an exhibit attached to the agreement as far as payments.

Q. And that exhibit is attached to the settlement agreement?

A. Yes. That's correct.

I just don't recall, sitting here right now, if I would –

Apparently on the last page, it does indicate that the total payments made from '94 through '99 would be $3,650,000.

Q. Now, the decree and the settlement agreement were between Mike Boulware and Mal Sun Boulware; is that correct?

A. That's correct.

Q. Did Mike ask you any questions about Hawaiian Isles' position in this and whether or not they should or could pay this amount of money to Mal Sun?

A. Yes, he did. He basically asked that exact question.

Q. And what did you reply to Mr. Boulware?

A. Well, I told him, from two respects:

One, if you have a person that you are divorcing, the probabilities of her being a person you could work with, if she got her marital interest in the corporate stock, would probably be, you know, pretty slim to

none; and it would behoove him to have the company, Hawaiian Isles Enterprises, basically be the entity that would buy out her claim, whatever [73] her claim consisted of, a marital interest, whatever, to buy her claim out, in order to keep the company running smoothly.

Q. And what – did Mike take any steps to have the company buy her claim out?

A. I believe that's what occurred.

Q. And, again, why did you believe the company should buy this out?

A. One thing you don't want in a – from my experience; and I explained this to Mike – one thing you don't want in a company where one person is a driving force is to have a receiver appointed to represent the wife's interests or to have her actually try to perfect her interests, because business will not go forward as smoothly as it should.

And I felt that was the interest of Hawaiian Isles, why they should buy it out. And I suggested that they do buy her out.

Q. You suggested Hawaiian Isles buy her out?

A. Yes.

Q. And, to your knowledge, they did; is that correct?

A. That's my understanding.

Q. All right.

I want you to shift your interest for a minute to another subject matter.

THE COURT: Well, let's take our morning recess at this time.

[74] THE CLERK: All rise.

Jurors, right this way, please.

(A recess was taken from 10:37 to 10:58 a.m.) (The following proceedings were held in open court, in the presence of the jury:)

THE COURT: You may continue.

MR. O'CONNOR: Thank you, Your Honor.

BY MR. O'CONNOR:

Q. Mr. McCarthy, did there come a time when Mr. Boulware asked you to do some legal work regarding a trust for his son?

A. Yes, there was.

Q. What occasioned that, if you know?

A. I –

THE COURT: Well, that question's not clear, what occasioned it.

BY MR. O'CONNOR:

Q. Why did he do that?

A. Well, what I was told by Mike at the time was that – what I was told was that he and Mal Sun had not had any children, and he had a child with another person, and that he wanted to basically take care of the child's future by way of setting up a trust.

And we had a number of meetings at my office where that subject matter was discussed. And eventually a trust was created for his son Glenn.

[75] Q. And the boy's name was Glenn?

A. Yes.

Q. Did he discuss with you at that time what should be placed into the trust?

A. Yes.

Q. And what was that – what did he suggest or did you suggest be placed in the trust?

A. I remember we talked about it. He was obviously – he basically said what a lot of dads say, I'm building the company for my kids and I want half the stock, if I remember properly, to go in – half the stock in HIE, Hawaiian Isles Enterprises – and some, if I remember properly, a relatively minimal amount of cash to open a bank account, that type of thing.

Q. Did you do a trust?

A. Yes, I did.

Q. I ask you to look at Exhibit 1005, which is in that file before you. It's the first document.

A. (Perusing documents.)

I have it in front of me.

Q. Is this the trust that you created?

A. Yes.

Q. This is dated September the 8th, 1987; is that correct?

A. That's correct.

Q. Who is the trustor, or the person who is going to hold [76] this stock in – for the trust? Who is the trustor of the trust?

A. Jin Sook Lee.

Q. And is that Glenn's mother?

A. Yes.

MR. O'CONNOR: Your Honor, at this time we offer Exhibit 1005 into evidence.

THE COURT: That may be admitted.

(Exhibit 1005 received in evidence.)

BY MR. O'CONNOR:

Q. Did Mr. Boulware have further discussions with you about the role of Ms. Lee as trustee?

A. Well, there was a point in time when we, Mike and I, had discussed the possibility of various monies going to Jin Sook Lee from Hawaiian Isles

Enterprises. And I provided him with some advice concerning what her obligations were.

Q. What was the purpose of that money that was going to go to her from Hawaiian Isles Enterprises?

A. To buy back the stock that I had said that Mal Sun would have either an equitable interest in or a marital interest in, that it was to go back – the cash was to go back to Hawaiian Isles, and that would be used to retire the stock interest, or to buy her claim out, so to speak.

Q. So this was going to be Hawaiian Isles' money, to buy out the domestic claim that she had to the company; is that [77] correct?

A. That's correct.

Q. Did something take place in that area? Did they start putting money somewhere?

A. From what I could recall, a substantial amount of money was given to Jin Sook under those terms, and that the money was to sit, intact, until the divorce and a number of other things had been resolved, and then given back to HIE, to close the buy-back of the stock.

Q. Buy-back of Mal Sun?

You told us earlier that she, Mal Sun Boulware, didn't have any stock in HIE; is that correct?

A. Not in a technical-technical sense. But since she was the spouse of Mike when the company was created and when it flourished, she would have this marital interest in it.

So that at the time of the divorce, if it was a contested divorce, the court in my mind would, black-and-white, award her 50 percent of the stock in HIE.

Q. To her?

A. To her.

Q. All right.

A. Or 50 percent of the value of the company to her. One or the other.

Q. Did Mr. Boulware ask you what capacity Jin Sook Lee would be in if she held this money to buy out Mal Sun's interest?

[78] A. He did.

Q. And what did you tell him?

A. I told him that she would have to hold it as a trustee, she had various fiduciary duties, since the beneficiary of the trust was Glenn, her son, and she knew darned well from the beginning what the purpose of the money was and what it was to be used for, that she would be either an out-and-out trustee for those funds or a constructive trustee, and they had to be held, intact, to be used for the purposes for which they were designated.

Q. Now, shifting to a different subject.

Did there come a time when Mr. Boulware asked for your advice concerning tobacco taxes and the payment of the tobacco taxes to the State of Hawaii?

A. Yes, he did.

Q. And what was the nature of –

MR. OSBORNE: Your Honor, I am going to object to the relevance of this question.

THE COURT: Well, it does not appear relevant.

MR. O'CONNOR: All right, let me lay a little foundation with the witness, Your Honor.

THE COURT: Well, let's do that.

BY MR. O'CONNOR:

Q. Was HIE required to pay taxes on tobacco sales and purchases in the state of Hawaii?

* * *

[88] Q. All right.

Now, about the trust – (perusing documents) – about the trust:

You set up a fully documented trust – we have it now in evidence – where the trust running in favor of the son; is that correct.

A. Yes.

Q. And it provided for the deposit of shares, and the opening of a bank account, and the transfer of some money?

A. Yes.

Q. And that was all to Jin Sook Lee?

A. For the benefit of the son. Yes.

Q. Right.

Now, you didn't set up a trust in which monies were transferred to Jin Sook Lee for the benefit of Mal Sun Boulware on the occasion of her divorce, did you?

A. No.

Q. And, in fact, the money that was transferred to Jin Sook Lee went in a safe in the floor of the house, didn't it?

MR. O'CONNOR: I object, Your Honor. There's no evidence of that yet.

THE COURT: Overruled.

If you know, you may answer.

A. I don't know where it went. All I know is that money was transferred for the purposes I described earlier.

[89] BY MR. OSBORNE:

Q. And did you see that a bank account was opened?

A. No.

Q. And there were absolutely no legal documents prepared by you concerning this arrangement, the transfer of money to Jin Sook Lee for Mal Sun's benefit?

A. The trust.

Q. The trust was in favor of whom?

A. It was in favor of Glenn.

Q. All right.

A. Glenn was a 50 percent shareholder of the company –

Q. Listen to my question:

You drafted no documents appointing Jin Sook Lee the trustee for the benefit of Mal Sun Boulware, did you?

MR. O'CONNOR: Asked and answered, Your Honor.

THE COURT: Yes, it has been.

MR. OSBORNE: Well, I –

THE COURT: It's been asked and answered.

MR. OSBORNE: I'm not sure he's given us a clear answer, Your Honor. I think it calls for a yes or no.

THE COURT: Well, you didn't prepare any such documents?

THE WITNESS: A clear "no." I did not. I was not requested to.

THE COURT: All right.

* * *

[160] and not to form or express any opinions or conclusions about this case until it has been submitted to you.

You are excused.

THE CLERK: All rise for the jurors.

(The jury was excused at 1:14 p.m.)

(The following proceedings were held in open court, outside the presence of the jury:)

THE COURT: I can think of no conceivable theory of admissibility for this group of documents labeled Exhibit 2010, because it is a conglomerate of things, including deposition testimony, including copies of checks, including statements of banks, etc.

So the court will – that will not be the last word.

If you file with me a justification to admit this under some pertinent evidentiary rule, I will consider it. But, as of now, I'm not –

And you're the one that objected to it. You should file whatever objection that you have, other than your – other than that you don't like it.

MR. DWYER: Yes, Your Honor.

THE COURT: That is not a good objection. Which both sides have used.

Now, the other issue:

One other issue, that the government has filed a motion in limine to preclude the introduction of evidence [161] relating to the issues of constructive distribution and return of capital.

This motion would prevent the defendant from arguing that monies diverted from Hawaiian Island to Boulware were actually a return of the defendant's capital investment in the company.

I want to quote to you now from a case, which I will cite in a moment:

"Evidence of unexplained funds in the taxpayer – of the tax – in the hands of the taxpayer establishes a prima facie case of understatement of income, making it incumbent on the taxpayer to overcome the logical inferences drawn from the facts proved," end quote, United States versus Garcia, 412 F.2d, 999, cited with approval by the Ninth Circuit in United States versus Miller, 545 F.2d, 1204.

Once the government had made out a prima facie case, in order for constructive distribution rules to apply, I quote again. This is from Miller .

Quote, "There must be some demonstration on the part of the taxpayer and/or the corporation that

such distributions were intended to be such a return," end quote. Miller.

Now, as Miller held, it is not relevant whether the funds could have been classified as return of capital or a dividend at the time they were diverted.

There is a violation given where the diverted funds [162] could have qualified as a return of capital, when the taxpayer fails to report the money as income or record it as a return of capital on the corporate books.

Here, the government has made out the prima facie case required by Miller.

Thus, if the constructive dividend rules are to apply, the defendant must make the requisite showing that the distributions were intended to be a return of capital.

As the government points out, Mr. Manago, who was a witness, who was an employee of the defendant, has testified that there were no returns of capital during the years in question.

Unless the defendant introduces competent evidence that demonstrates otherwise, the constructive distribution rules would apply to this case – would not apply.

Because of the confusing and potentially prejudicial nature of this evidence, the court believes the matter should be resolved either in a hearing under Federal Rule of Evidence 104, which is to determine

the existence of the preliminary facts necessary for admissibility, or if the defendant can make a showing by a written offer of proof, which the court will then consider in determining this issue.

So, what we will do is this:

We will probably hold a hearing.

I'll give you the choice. If you want to present [163] the evidence to the court outside the presence of the jury to demonstrate what I have just said, then I will consider that, and rule accordingly on the issue.

The court cannot rule at this point in time; in other words – for the reasons I have stated.

All right. Now, I think that that is all. We will reconvene on Tuesday, at 9:00 a.m. Try not to blow yourselves up, either. (Laughter in the court.)

THE CLERK: All rise.

(The hearing in the above-entitled cause was concluded at 1:17 p.m.)

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	CR NO. 99-00239 ER DEFENDANT MICHAEL H. BOULWARE'S MOTION FOR LEAVE TO PRESENT EVIDENCE OF REPORTING OF EXCESS INCOME BY HIE, OFFER OF PROOF AND REQUEST FOR FRE RULE 104 HEARING

DEFENDANT MICHAEL H. BOULWARE'S MOTION FOR LEAVE TO PRESENT EVIDENCE OF REPORTING OF EXCESS INCOME BY HIE, OFFER OF PROOF AND REQUEST FOR FRE RULE 104 HEARING

Defendant MICHAEL H. BOULWARE (hereinafter "Defendant" or "Boulware"), by and through his attorneys, Reinwald, O'Connor and Playdon LLP, respectfully moves this Honorable Court for leave to present evidence of excess income reported by Hawaiian Isles Enterprises, Inc. ("HIE") during the relevant years on the grounds that such evidence is highly relevant to disprove the elements of intent and tax evasion and false information. The evidence of HIE's reporting of excess income is also relevant to prove that the instant case is not a corporate diversion case.

Defendant Boulware also submits the instant Motion as an offer of proof as to the evidence of HIE's

reporting of excess income and its relevance to Boulware's defenses. Boulware further requests a preliminary evidentiary hearing pursuant Rule 104 of the Federal Rules of Evidence ("FRE") if the Court is not inclined to grant this Motion based on this written submission.

This motion is brought pursuant to this Court's oral ruling on June 30, 2005, FRE Rule 104 and is based upon the memorandum, declaration of counsel and exhibit attached hereto and the record and files herein.

DATED: Honolulu, Hawaii, July 5, 2005.

/s/ [Illegible]
DENNIS E. W. O'CONNOR
Attorney for Defendant
MICHAEL H. BOULWARE

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	CR NO. 99-00239 ER MEMORANDUM IN SUPPORT OF MOTION HEARING DATE: TIME: JUDGE: EDWARD RAFEEDIE TRIAL DATE: JUNE 27, 2005

MEMORANDUM IN SUPPORT OF MOTION

I. INTRODUCTION

Pursuant to this Court's oral ruling on June 30, 2005, Defendant Boulware hereby moves this Court for leave to present evidence of the reporting of excess income by HIE because, for the reasons discussed more fully below, such evidence is highly relevant and integral to Defendant Boulware's defense to the charges alleged against him by the government. The government essentially alleges that this is a corporate diversion or skimming case whereby Boulware is alleged to have diverted funds intended for HIE such that HIE never reported the funds as income or obtained funds from HIE through other means for his own personal purposes.

In order to rebut the government's allegations, Defendant Boulware intends to present evidence, both from expert and non-expert witnesses, that will prove that, contrary to the government's position, all of the monies allegedly diverted by Boulware from HIE were indeed reported as income by HIE through the over-reported income. Defendant Boulware further intends to prove that all funds at issue were corporate advances or loans or were being used for corporate purposes and that Boulware always understood as much.

Boulware will also present evidence that the funds that the government claims to be unreported income had indeed been contemporaneously reported as income by HIE through the reported excess income

and that such funds were contemporaneously recognized by HIE as being assets of the corporation. For these reasons, which are discussed more fully below, Defendant Boulware submits that the evidence of HIE's reporting of excess income during the tax years at issue is highly relevant and crucial to the presentation of his defense to the tax charges in this case.

Defendant Boulware will discuss below the factual or evidentiary support for the relevance of HIE's reporting of excess income. To the extent that the factual support is not as yet in evidence, Boulware submits the stated facts as his offer of proof

Should the Court find that the stated offer of proof is not sufficient, Boulware respectfully requests a further evidentiary hearing pursuant to FRE Rule 104 to present any testimonial or documentary evidence to address any inquiry or concern of the Court.

II. FACTUAL SUPPORT

Defendant Boulware intends to present evidence through Merwyn Manago, the comptroller of HIE during the relevant years, that from 1989 through 1995, at Boulware's direction, Manago made monthly contemporaneous adjustments to HIE's books. In these monthly adjustments, Manago credited or reduced the amount of the cost of goods sold thereby causing a reporting of an excess amount of reported income taxable to HIE. Manago also contemporaneously debited the amount of the tobacco tax liability thereby causing an increase in HIE's reported net

assets. Defendant Boulware will present expert testimony that such accounting practices conformed to generally accepted accounting practice.

Defendant Boulware will present father evidence from Manago that, although he was not aware of the actual components of the monthly adjustments at the time he made them, he later learned through reclassification entries that the monthly adjustments were comprised of recapture of excess tobacco taxes previously paid, monies used by Boulware from over-the-counter sales, and income generated by Defendant Boulware's from off-book activities. Manago therefore entered adjustments in the HIE accounting journals to reflect the proper classifications of the components of the monthly adjustments. Defendant Boulware will present expert testimony that the reclassification entries done after the fact is wholly consistent with recognized and accepted accounting practices.

Defendant Boulware will present expert testimony to explain that once HIE recognized the excess or over-reported income as company assets, the monies in Boulware's hands, as the controlling shareholder of a closely held corporation, could either be non-taxable if they are considered to be corporate advances or loans or potentially taxable if they are considered to be constructive dividends or return of capital. The expert will further explain that if Boulware used the monies for corporate purposes, the monies were not income to Boulware. Alternatively, the expert will explain that if the monies were not loans or advances or if Boulware did not use the

monies for corporate purposes, then as the controlling shareholder, the monies could be deemed a constructive dividend or return of capital to Boulware which may or may not be income depending on whether or not HIE had earnings and profits for the years when the monies were obtained by Boulware.

Defendant Boulware will also present evidence that during the charged tax years, he was the president, secretary and treasurer of HIE and the controlling shareholder. Boulware will present further evidence that all of the alleged unreported income was either a loan or advance or was used by Boulware for corporate purposes or for the benefit of HIE. Boulware will present further evidence that at no time during the relevant years was Manago an officer of HIE. The evidence will therefore show that Manago's knowledge or lack thereof regarding Boulware's use of the funds for off-book transactions are not determinative as to whether HIE was aware of the off-book transactions.

The evidence will also show that Manago advised Boulware that the adjustments that Boulware directed Manago to make monthly would increase HIE's reported income. Therefore, the evidence will establish that by directing Manago to make the monthly adjustments to reflect additional income, Boulware intended that the over-the-counter sales and off-book income be reported as HIE income.

Based on the above, Boulware submits that the evidence will explain that the overstated or over-reported

income by HIE from 1989 to 1995 represented assets of HIE which, in the hands of Boulware, were either used by Boulware for corporate purposes or were corporate advances or loans and therefore were not income to Boulware. Boulware will present further evidence that goods, monies and properties that were derived from the corporate advances were returned to HIE, especially through the state court judgment. Boulware will also present evidence of that certain off-book transactions were properly booked to Boulware as officer loans and that he has repaid a substantial portion of such loans.

For these reasons, Boulware submits that the excess income reported by HIE for the years 1989 through 1995 is highly relevant and significant to his defense that the alleged unreported income was never income to him personally and that he intended to either use such monies for anything other than corporate purposes or treat them as loans or advances from HIE.

III. LEGAL SUPPORT

The reporting of excess income by HIE is relevant to Boulware's defense in two ways. First, the over-reported income establishes Boulware's lack of willfulness in that he caused the over-the-counter sales proceeds and the income from his off-book activities to be reported as income by HIE. *U.S. v. Thompson,* 23 F.3d 1225, 1228, n.4 (7th Cir. 1994) (individual's filing of personal income on corporate tax return may

show lack of intent to evade taxes) (citing *U.S. v. Gurtanca,* 836 F.2d 283 (7th Cir. 1987).

Second, the, over-reported income is evidence of Defendant Boulware's use of corporate funds for corporate purposes which renders the disputed funds as nontaxable to Boulware. In *Stone v. C.I.R.,* 865 F.2d 342 (D.C.Cir. 1989), the D.C. Court of Appeals observed that "even when a corporate officer is its sole shareholder (and thus in ultimate control), and he transfers corporate funds to his personal checking account, and his dealings with the corporation are 'extremely informal,' there is no constructive dividend so long as he can show that his intent 'was to use such funds for corporate purposes as an agent of the corporation.'" *Id.* at 343 (quoting *Nasser v. U.S.,* 257 F. Supp. 443, 449 (N.D. Cal. 1966)). In this case, it is Defendant Boulware's position that the funds that the government claims were income to him personally were instead corporate funds, as reported by HIE through the over-reported income, which he was using for corporate purposes as an agent of the corporation, HIE.

Furthermore, Defendant Boulware submits that, contrary to the government's contention, the fact that Manago, HIE's comptroller, may not have been aware of the funds or Boulware's use of the funds is not dispositive because, "[t]he knowledge of a director, officer, sole shareholder or controlling person of a corporation is imputable to that corporation." *Donovan v. Schmoutey,* 592 F. Supp. 1361, 1399 (D. Nev. 1984) (citations omitted). Therefore, Boulware's

knowledge that he was causing the over-the-counter sales and off-book income to be reported as HIE income through the monthly adjustments that he directed Manago to pick up is knowledge on the part of HIE that such income was HIE's income. In addition, Boulware's knowledge that he was using such funds for corporate purposes is imputed to HIE.

More importantly, in *Nasser* the federal district court for the Northern District of California observed that whether a distribution by a corporation to its sole stockholder is dividend income or funds transferred "to be used by him as an investment agent on behalf of the corporation for its purposes and therefore not a dividend [income]" is a question of fact. 257 F. Supp. At 447. The *Nasser* court further observed that the primary factual determination is the intention of the sole shareholder at the time the transfer is made. *Id.* In making that determination, the *Nasser* court noted that the trier of fact must consider three types of evidence: the testimony of the taxpayer himself, objective evidence which is contemporaneous with the transfer of funds, and "evidence as to the acts subsequent to the date of transfer." *Id.* Finally, the *Nasser* court noted that the trier of fact "must consider what the taxpayer did, not what he formally intended to do, nor what he declared by bookkeeping entries he had done. . . . However, the formal bookkeeping entries and ultimate disposition of the funds may be given as much weight as they deserve in the particular circumstances of the transaction in the context of a close corporation." *Id.* at 448.

In this case, the over-reported income is significant evidence that Defendant Boulware, at all times, believed that the funds at issue were HIE's corporate funds which were either loaned or advanced to him or used by him for corporate purposes and not funds transferred to him for personal use. Therefore, the over-reported income is highly relevant to Boulware's defense that he never realized personal income through the use of the funds.

DATED: Honolulu, Hawaii, July 2005.

/s/ [Illegible]
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UNITED STATES OF AMERICA

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, v. MICHAEL H. BOULWARE, Defendant.	CR. NO. 99-00239 ER MEMORANDUM IN OPPOSITION TO DEFENDANT'S MOTION FOR LEAVE TO PRESENT EVIDENCE OF REPORTING OF EXCESS INCOME BY HIE, OFFER OF PROOF AND REQUEST FOR F.R.E. 104 HEARING; CERTIFICATE OF SERVICE Trial: June 27, 2005 Judge: Edward Rafeedie

MEMORANDUM IN OPPOSITION TO DEFENDANT'S MOTION FOR LEAVE TO PRESENT EVIDENCE OF REPORTING OF EXCESS INCOME BY HIE, OFFER OF PROOF AND REQUEST FOR F.R.E. 104 HEARING

(Filed Jul. 6, 2005)

The United States of America, by and through the undersigned attorney, files this memorandum in opposition to the Defendant's Motion for Leave to Present Evidence of Excess Income by HIE, Offer of Proof and Request for F.R.E. 104 Hearing.

By way of the above-referenced motion, the defendant seeks leave of the court to present evidence relating to three separate areas: (1) the alleged over-reporting of HIE's income, *see* Def.'s Mem., pp. 1-2; (2) expert testimony regarding the reasonableness of various HIE accounting practices, *see* Def.'s Mem., p. 3, p. 4; and (3) expert testimony regarding the issue of constructive distributions and returns of capital, *see* Def.'s Mem., p. 4. For the reasons that hereinafter follow, the motion should be denied in its entirety.

1. HIE'S ALLEGED OVER-REPORTING OF INCOME:

The defendant seeks to introduce evidence regarding the fact that HIE allegedly over-reported its income during the prosecution years. Evidence of a corporation's income is irrelevant to a personal income tax prosecution. *See United States v. Miller,* 545 F.2d 1204, 1214 n.12 (9th Cir. 1976) (defendant has violated the tax evasion statute "once the taxpayer has assumed control of the funds and then fails to report such funds as income"); *see also United States v. Curtis,* 782 F.2d 593, 596 (6th Cir. 1986) (rejecting defendant's claim that he could not be convicted of tax evasion where corporation had paid taxes on the funds that he had diverted). The defendant nevertheless contends that this evidence is relevant in three ways. First, it allegedly rebuts the defendant's understanding of the government position that the corporation did not report the diverted funds at issue as income. Second, the defendant argues that this

evidence establishes "Boulware's lack of willfulness in that he caused the over-the-counter sales proceeds and the income from his off-book activities to be reported as income by HIE." Def.'s Br., p. 6. Finally, the defendant maintains that the "over-reported income is evidence of Defendant Boulware's use of corporate funds for corporate purposes which renders the disputed funds as nontaxable to Boulware." Def.'s Br., p. 6. Because the evidence of HIE's over-reporting its income is not relevant to the three areas identified by the defendant, the motion should be denied. Furthermore, the evidence should be excluded pursuant to Fed. R. Evid. 403.

Rebuttal of the Government's Case:

The defendant contends that evidence regarding HIE's alleged over-reporting of its income is relevant to rebut the government's purported position that HIE's income was under-reported during the relevant time period. Because the defendant misstates the nature of the government's evidence, this contention is incorrect. Put simply, the government has never alleged that the defendant's wrongdoing resulted in the corporation's under-reporting of income. Rather the government has maintained – indeed it is essentially undisputed – that the cash and checks resulting from various over-the-counter sales and bulk coffee sales were never reported as receipts on the corporate books because the defendant took those checks and cash for himself. In other words, the general ledger was not properly credited with the receipts of these

monies. This, however, does not mean that corporation under-reported its corporate income and the government has never maintained as much. Therefore the defendant's contention that the over-reporting of income rebuts the undisputed fact that various receipts of money were not reported on the corporate books, simply mixes apples with oranges. To contend that the two are the same would only lead to confusion of the issues and mislead the jury.

More importantly, however, whether the corporation recorded the receipts of these funds as income is ultimately irrelevant. The issue is whether the funds at issue were income to the defendant. The issue is not whether they could also be considered income of the corporation. Permitting this evidence would confuse the issues.

Willfulness:

The defendant next maintains that the over-reporting of income is relevant to the issue of willfulness. *See* Def.'s Br., p. 6. The willfulness issue in this case is whether the defendant knew that he had an obligation to report his personal income and whether he nevertheless failed to report that income. In other words, the willfulness inquiry focuses on what the defendant believed. *See United States v. Willie,* 941 F.2d 1384, 1392 (9th Cir. 1991). Whether the corporation ultimately over-reported its income is simply irrelevant to the issue of what the defendant thought and believed. Put simply, Boulware does not contend – according to the proffer in

the motion – that he will testify that he believed the corporation's reporting of the income nullified his responsibility to report the income as personal income; indeed, such a position appears contradictory to the defendant's repeated claim that the funds at issue were not income to him. Accordingly, HIE's alleged over-reporting of its income is not relevant to the issue of willfulness.[1]

Evidence of Corporate Purposes:

Finally, the defendant maintains that the "over-reported income is evidence of Defendant Boulware's use of corporate funds for corporate purposes which renders the disputed funds as nontaxable to Boulware." Def.'s Br., p. 6. According to the defendant, "it is Defendant Boulware's position that the funds that the government claims were income to him personally were instead corporate funds, as reported by HIE through the over-reported income, which he was

[1] The defendant relies on two Seventh Circuit cases for the broad proposition that evidence of an individual's reporting of personal income on a corporate return may show a lack of intent to evade taxes. *See* Def.'s Br., p. 6. Putting aside the fact that the defendant misstates those cases' holdings, both cases plainly indicate that the issue of willfulness focuses on the issue of the defendant's belief. *United States v. Thompson,* 23 F.3d 1225, 1228 n.4 (7th Cir. 1994); *United States v. Gartunca,* 836 F.2d 283, 285-86 (7th 1987). Thus, absent some showing that Boulware had a belief that the reporting of the income on the corporate books negated his duty to report the income, neither of the cases cited by the defendant make the issue of corporate income relevant.

using for corporate purposes as an agent for the corporation." Def.'s Br., p. 6. This offer of proof is similarly unpersuasive.

Whether the corporation reported the funds that are charged in this case as income is irrelevant to the issues in this case. The issue with regard to the 10 million dollars in this case is whether it was income to Michael H. Boulware. It is irrelevant whether these same funds were declared as income by the corporation. Further, the fact that the corporation had a legitimate claim to all of the funds charged as income in this case simply does not negate the fact that those funds may still be income to the defendant. *See James v. United States,* 366 U.S. 213, 219 (1961) ("When a taxpayer acquires earnings . . . without the consensual recognition . . . of an obligation to repay and without restriction as to their disposition, he has received income . . . even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.") Moreover, contrary to the defendant's contention, HIE's mere over-reporting of income does not make the funds "corporate funds" used for a corporate purpose. Accordingly, HIE's alleged over-reporting of income is irrelevant to the issue of whether the funds at issue were corporate funds.

Fed. R. Evid. 403

Even if the defendant could establish that HIE's alleged over-reporting of income had marginal probative value, the evidence should nevertheless be excluded because it is misleading, confusing and will unnecessarily lead to delay of the trial. Notably, the defendant does not intend to simply offer evidence of HIE's alleged over-reporting of income. Rather, in order to explain how the income was over-reported, the evidence will show that the accounting involved was not a simple increase in the company's income. The precise accounting involved multiple contemporaneous adjustments to the corporate books. Specifically, the books were adjusted to: falsely state the cost of goods sold of tobacco products; adjust up the excise tax payable account on the other side of the books; and also reclassify the sales of various goods. These month end adjustments – allegedly – resulted in the increase of reported income. In addition, the defendant will also, apparently, present evidence relating to subsequent reclassifications of these entries that were intended to reclassify the previous adjustments for purposes of accounting for the defendant's off-book activities.

Explanation of these adjustments will require extensive testimony and cross-examination of issues that are simply not relevant to the issues in this case. Because these issues are not relevant they will only mislead the jury, confuse the issues and ultimately lead to unnecessary delay of time. Accordingly, any marginal relevance of HIE's alleged over-reporting of

its income is substantially outweighed by these factors and should be excluded pursuant to Fed. R. Evid. 403. *See United States v. Iskander,* 407 F.3d 232, (4th Cir. 2005) (trial court properly excluded evidence and testimony relating to corporation's tax status under Fed. R. Evid. 403 in personal income tax evasion case).

2. Expert Testimony:

By way of the instant motion, the defendant also seeks to offer expert testimony regarding the propriety of the accounting entries that resulted in HIE's alleged over-reporting of income. Def.'s Br. p. 2, p. 3, p. 4. Whether HIE over-reported its income is a fact questions it is not a question requiring specialized or technical training. Moreover, to the extent that expert evidence is being offered to show the propriety of the accounting practices of HIE, it should not be allowed because it is irrelevant.[2] Whether the HIE's actions were reasonable is not relevant. Accordingly, the motion should be denied insofar as it seeks leave to

[2] This court has previously ruled that the defendant is not permitted to introduce expert evidence relating to the what the law is or whether the law is confusing. *United States v. Scholl,* 166 F.3d 964, 972-73 (9th Cir. 1999) ("The reasonableness of [the defendant's belief] is irrelevant; the only relevant issue is whether [the defendant] actually had this belief."). Expert testimony relating to the propriety of HIE's accounting practices should be similarly excluded. Not only is irrelevant it is simply offered to bolster the credibility of fact witnesses.

offer expert testimony regarding HIE's alleged over-reported income and the propriety of HIE's accounting practices.

3. Corporate Distributions, Constructive Dividends and Returns of Capital:

Although not explicitly stated in the motion caption, the defendant also seeks to offer "expert testimony to explain that . . . the [diverted] monies in Boulware's hands, as the controlling shareholder of a closely held corporation, *could* either be non-taxable of they are considered to be corporate advances or loans or potentially taxable if they are considered to be constructive dividends." Def.'s Br., p. 4 (emphasis added). This court has already excluded evidence of this type when it granted the United States' motion *in limine* regarding the applicable law and United States' motion *in limine* regarding corporate distributions and returns of capital. The defendant has failed to articulate any reason why those rulings should be revisited.

First, with regard to the defendant's intention to offer expert testimony regarding the possible tax consequences of the defendant's receipt of funds at issue in this case, that is an issue of law. To permit expert testimony in this regard would usurp the court's authority and lead to unnecessary confusion of the issues. *Cooley v. United States,* 501 F.2d 1249, 1253-54 (9th Cir. 1974) ("the law is given by the court and not introduced as evidence"); *accord United*

States v. Willie, 941 F.2d 1384, 1396 (10th Cir. 1991), *cert. denied,* 502 U.S. 1106 (1992). Accordingly, the defendant should not be permitted to offer expert testimony explaining what types of money transfers are taxable.

Similarly, this court has already concluded that the defendant may not present any testimony, argument or evidence relating to the issues of constructive distributions or returns of capital without laying the necessary foundation. *See United States v. Miller,* 545 F.2d 1204, 1214 (9th Cir. 1976) ("there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be [a return of capital]"). The defendant's motion does not contain any such proffer. Rather, it simply seeks to offer expert testimony regarding how the funds at issue "could" be characterized. Therefore, to the extent that the defendant seeks to offer testimony regarding how the funds at issue could be characterized and the accompanying tax effect – such evidence should be excluded based on the court's prior ruling and the defendant's failure to lay the necessary foundation.

Conclusion:

For all of the reasons expressed herein, the United States respectfully requests that the Defendant's Motion for Leave to Present Evidence of Excess Income by HIE, Offer of Proof and Request for F.R.E. 104 Hearing be denied.

DATED: July 6, 2005 at Honolulu, Hawaii.

Respectfully submitted,

EDWARD H. KUBO, JR.
United States Attorney
District of Hawaii

By /s/ Leslie E. Osborne, Jr.
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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA,	)	
Plaintiff,	)	CRIMINAL NO. 99-00239ER
vs.	)	
MICHAEL H. BOULWARE,	)	– VOLUME 8 –
Defendant.	)	

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Monday, July 11, 2005, at 9:07 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

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* * *

[24] commercial litigation.

Q. In your experience, is it common practice to value businesses in marital disputes?

A. Where the attorneys for the parties deem it significant, yes, it is often the case.

Q. In this particular case, we have asked you to value some businesses, have we not?

A. That's correct.

Q. And the businesses that we have asked you to value are the Hawaiian Isles Enterprises water company –

First, is that correct? Is that one of them?

A. Yes, it is. More specifically, I was asked to value a 100 percent ownership interest in Royal Hawaiian Water Company.

Q. Yes.

A. Which later became a subsidiary of – or an affiliate of Hawaiian Isles Enterprises.

Q. Is that company also known as Hawaiian Isles Water Company?

A. (Perusing documents.)

Yes, sir. It does business under that trade name.

Q. What steps did you take in order to value that company?

First of all, were you given a specific date to value that?

A. I was actually requested to value that company as of two [25] dates. The first being June 30th, 1997; and the second being June 30th, 1998.

Q. Do you know why you were given two dates?

A. I don't know. I was engaged by the CPA firm for the company, and I understood it was for corporate and tax planning.

Q. Okay.

A. But I don't know why there were two specific dates.

Q. And the CPA firm is the Kobayashi Doi and Lum firm?

A. That's correct.

Q. What did you do in order to value Hawaiian Isles Water?

A. Well, I did what I would do in any circumstance like this, where we had this assignment.

And that's to gain an understanding of the business that we have been hired to value. That is, to understand its resources, in other words, you know, its workforce, its historical financial statements, its – to do a survey of competition, the economy in which it operated, the industry in which it operated.

All towards the end of understanding what an investor would be willing to pay to own, in this particular circumstance, a 100 percent ownership interest.

Q. What was the business of Hawaiian Isles Water Company?

A. (Perusing documents.)

They distributed bottled water products in Hawaii, [26] and they have done so since 1996.

Q. So what did you do in order to value the company?

A. (Perusing documents.)

Well, we studied its historical operating results, interviewed the controller, interviewed their CPA who had been serving that company for – since its creation.

I analyzed its ability to pay distributions.

I looked for similar – I looked at transactions involving similar businesses.

I should explain, just briefly, that there are three general approaches to valuing a business.

One of them is commonly used for valuing residential property. It's called market approach, in that circumstance. The other two are the income approach and the asset-based approach.

In the income approach, we work to understand the ability of the company to distribute income to an owner.

And in the third approach, which I mentioned earlier, the asset-based approach, we looked to understand the value of the assets that a company may own.

That last approach is more appropriate for companies that just own real estate or just own marketable securities.

It can be used to value growing concerns, but it's not my preferred method of doing so.

In this circumstance, I found that the most [27] appropriate method was the market approach.

Because I found that there was a company called Hawaiian Natural Water that had actually gone public; in other words, it had issued stocks on the public market, in May of 1997. And up through the – it had been trading stocks subsequent to that event.

So I studied Hawaii Natural Water, because it had a similar marketplace, similar product: Water from Hawaii.

And based on its – (perusing documents) – ratio of price per share, market capitalization, divided by annual sales, derived a factor for valuing the subject, Hawaiian Isles Water.

Q. How did you – did you value this as an ongoing business?

A. Oh, certainly. It was a going concern. There was no question about that.

Q. And specifically what did you fix the value of the company at?

A. (Perusing documents.)

I determined that the fair market value of the 100 percent interest in the company at June 30, 1997 was $1,572,000.

With respect to the June 30th, 1998 date, I determined that the fair market value of the similar interest was $1,722,000.

Now, I should mention that, in addition to accepting [28] the assignment to determine the fair market value of the business, I was also asked by Mr. Kobayashi, of the CPA firm, to determine the investment value of the businesses to Hawaiian Island Enterprises.

I should explain what the difference is between fair market value –

Q. Please do.

A. – and investment value.

Fair market value is generally described as the price for a particular property that a willing buyer would pay and a willing seller would accept, where both are reasonably informed about the relevant information and neither party's acting under duress.

So that's what fair market value is.

Investment value is the value to a particular party.

For instance, the values that you'll see traded on the public stock exchanges, New York Stock Exchange, the American Stock Exchange, and the Nasdaq, is the fair market value that investors would pay to own a share or 100 shares in a particular company.

Often, if you have the time to read the financial pages, you'll see that public companies will buy each other, or sometimes venture capitalists will buy another company for a price in excess, higher than what's normally traded on the marketplace.

[29] For instance, a stock in the company might be at $27, for example. And another company who wants to acquire it will offer $30 or $32.

That's because, in the eye of the beholder, the buyer, will see that it's worth more for them to control this other company, they perceive perhaps savings in expenses, they will only need one chief executive

instead of two, they will only need one controller rather than two, that type of thing.

So the investment value to that acquiring company is higher than the fair market value might be.

And in this circumstance, I was asked to estimate the investment value to Hawaiian Isles Enterprises.

I did that –

Q. Did you do that on two dates, also?

A. I did that on two dates.

Q. And what are the two dates, again?

A. The two dates are June 30th, 1997 –

Q. And what was the investment value on that date of the company?

A. $1,826,000.

Q. And the other date was what date?

A. The other valuation date was June 30th, 1998.

Q. What was the value of the water company on that date?

A. $2,182,000.

Q. Did you put all of this information into a report?

[30] A. Yes, I did, sir.

Q. Is that report Defendant's Exhibit 1665?

A. I have not reviewed the exhibit, sir.

Q. Do you have a booklet there before you –

A. Oh, I'm sorry, yeah.

Defendant's Exhibit 1665?

Q. Yeah.

Turn, if you would, to 1665.

A. (Perusing documents.)

Q. Is that your report?

A. Yes, sir, it is.

MR. O'CONNOR: Your Honor, at this time we offer Exhibit 1665 in evidence.

THE COURT: Any objection?

MR. O'CONNOR: No objection.

THE COURT: Very well. It may be admitted.

(Exhibit 1665 received in evidence.)

BY MR. O'CONNOR:

Q. In addition to valuing the Hawaiian Isles Water Company, were you asked also to value the coffee-processing and wholesaling business which had been established by Mr. Boulware?

A. That is correct.

I was asked to estimate the fair market value of that business as of July 1, 1992.

[31] In addition, similar to the other assignment, I was also asked to estimate the investment value.

Q. All right.

Who asked you to do that?

A. Again, it was Mr. Kobayashi, of the Kobayashi Doi & Lum CPA firm.

Q. As you sit there, I take it you don't know why they asked you?

A. I understood it was in connection with corporate and tax-planning purposes.

This is not unusual for me to accept an assignment of this kind.

THE COURT: Well, you've answered the question.

BY MR. O'CONNOR:

Q. What steps did you take in –

What is this business? What business were you valuing?

A. (Perusing documents.)

This is a business in which coffee beans were purchased from coffee farmers, processed into coffee grounds, fine or coarse, and marketed, in Hawaii and elsewhere.

Typically it was Kona coffee.

THE COURT: Well, and your report identified this as valuation of a 100 percent interest in Mr. Michael Boulware's coffee-processing and wholesaling business?

[32] THE WITNESS: Yes, Your Honor.

THE COURT: All right.

That is what you evaluated?

THE WITNESS: That's correct, Your Honor.

BY MR. O'CONNOR:

Q. What steps did you take in order to value that business?

A. (Perusing documents.)

Well, similar to the other business, I familiarized myself with the business' operations, its resources, the economy and industry in which it operated.

You may recall that I explained that there were three generally used approaches to valuing a business

In this circumstance, I could not locate transactions involving similar businesses. So I relied on –

And the asset-based approach was not useful, because of the going concern nature of this business.

So I relied on – or used the income approach.

And in doing so, I studied the company's revenues and expenses – (perusing documents) – and – (perusing documents) – made some estimates as to what its expenses would be if it were not relying on warehousing and other help from other companies that Mr. Boulware owned at the time – I think there were conservative estimates of additional expenses that a buyer would have had to incur to operate the businesses – and determined what the, going forward, free cash-flows [33] from the business would be.

I determined those businesses would generate about $330,000 – or this business would generate about $330,000, on an average, going forward.

I determined that an investor would require close to 16 percent annual return. Which is a very high return. Because there is a certain amount of risk in a small business.

I considered that this would be a 100 percent interest, rather than a fractional interest, and that of a small premium for control involved in that, arriving at a preliminary figure of $2,310,000.

I then took a very dramatic discount in that value, in order to recognize that this was a small business that was not traded on the New York Stock Exchange or on any other stock exchange.

I discounted the preliminary indication by 20 percent. To arrive at a fair market value conclusion, as of the valuation date, of $1,850,000.

Q. Did you make a conclusion regarding the investment value?

A. Yes, sir, I did.

And in doing that, I studied the annual savings that Hawaiian Island Enterprises would have enjoyed by merging the two companies.

I estimated that the value to Hawaiian Island Enterprises, over and above the fair market value, was [34] $960,000.

This resulted in a conclusion of investment value to Hawaiian Island Enterprises of $2,800,000 for this business, as of July 1, 1992.

Q. And did you render a report setting out what you've done, and that value?

A. That's correct.

I wrote a report documenting my – summarizing my work and documenting my conclusions, and –

Q. I ask you to turn to Defendant's Exhibit 1668, which is in the book before you.

A. (Perusing documents.)

Yes, I have that before me.

And – (perusing documents) – this is –

Q. Is that the report?

A. This is my report.

Q. And that sets out the investment value of this coffee business; is that right?

A. That's correct.

MR. O'CONNOR: Your Honor, we offer Exhibit 1668 in evidence.

MR. O'CONNOR: No objection.

THE COURT: It may be admitted.

(Exhibit 1668 received in evidence.)

MR. O'CONNOR: I have no further questions.

[35] Thank you.

THE COURT: You may cross-examine the witness.

MR. OSBORNE: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. OSBORNE:

Q. Sir, you found the water company to be a sole proprietorship, right?

A. I believe that's so.

Q. Okay.

I was asking you, because at Page 15 of 1665 – I think it's Page 15; I might have gotten a little off

there – (perusing documents) – I believe you referred to stock in the company.

But there was no stock, was there?

A. I don't recall that there was stock.

I'm having trouble finding the reference you're referring to.

Q. Okay.

But it was, to the best of your knowledge, a sole proprietorship?

A. To the best of my recollection.

Q. Okay.

Did you determine where the monies came from to invest in the water company?

A. No.

[36] Q. And who did you understand the sole proprietor was?

A. I understood it was Mr. Boulware.

Q. Was that a profitable company? Did it make a profit at any time during its history? Before he turned it over to Hawaiian Isles.

A. (Perusing documents.)

No, sir. Based on my analysis, it did not make money.

Q. Okay.

Now, I assume, sir, you are also acquainted with personal income tax returns. Is that correct?

A. Yes, I am.

Q. And, as a sole proprietorship during the years in question, Mr. Boulware would have been required to file a Schedule C, wouldn't he? On his personal return?

A. I imagine that's so.

Q. Did you check to see if he filed a Schedule C?

A. I don't recall that I did.

Q. And what's the purpose of the Schedule C?

A. I use the Schedule C to record income from my sole proprietorship.

Q. Okay.

Now, how about the coffee company? Was that also a sole proprietorship?

A. To the best of my recollection, yes.

[37] Q. And, again, you don't know where Mr. Boulware obtained the money to start that company, do you?

A. That's correct.

Q. And, again, if it was a sole proprietorship, there should have been a Schedule C, shouldn't there?

A. I haven't studied that in this circumstance –

THE COURT: Well, sir, you are a CPA, aren't you?

THE WITNESS: I am.

THE COURT: And you're not able to answer that question?

THE WITNESS: I can answer it based on my general knowledge of tax returns and tax reporting and say –

THE COURT: Well, as a person that operates a business is required to report the profit or gain or loss from the business on his individual income tax return; is that not true?

THE WITNESS: If he owns it as a sole proprietor, yes.

THE COURT: If you don't what?

THE WITNESS: If an individual owns a business or an enterprise as a sole proprietor, then yes, they would report it on Schedule C.

BY MR. OSBORNE:

Q. Okay.

And you know this was a sole proprietorship?

* * *

[89] Q. What are they?

A. As I indicated, the first – two, four, six – seven columns would look identical to the annual schedules that I prepared for officer loans, loans to stockholder.

THE COURT: Well, are there stockholders in this company?

THE WITNESS: There are – not to whom loans are made, no.

THE COURT: Well, it says schedule of loans to stockholder on the record – on the schedule there.

THE WITNESS: Yes.

THE COURT: Stockholder?

THE WITNESS: Yes.

THE COURT: What is meant by that?

THE WITNESS: Pretty much loans that were made to Mr. Boulware.

BY MR. O'CONNOR:

Q. There are other stockholders in the company, are there not? For example –

A. Yeah.

Q. – Sydney Boulware owns stock in the company?

A. No.

Q. Today he does not?

A. No.

Q. Has he been a stockholder?

[90] A. There was a time that he had stock, to my knowledge. But I think as a result of the civil litigation, if I'm not – if I remember correctly, it was invalidated.

Q. All right.

There is stock being held in a trust in this company, is there not?

A. Yes.

Q. And what is that trust?

A. The Glenn Boulware trust.

Q. And is the Glenn Boulware trust a stockholder of the company?

A. Yes. A 50 – I think it was a 50 – they are a 50 percent owner.

Q. And Mr. Mike Boulware owns stock in the company; is that not correct?

A. Yes.

Q. He is a 50 percent owner?

A. Yes.

Q. Let's look at Exhibit 1595.

A. (Perusing documents.)

Q. Do you see that?

A. Yes.

Q. Looking at that page and the pages that follow it in Exhibit 1595, what is that?

A. These are the schedule that I maintained for the loans to

* * *

[111] Enterprises?

MR. OSBORNE: Objection –

THE COURT: The objection is sustained.

MR. OSBORNE: – relevance.

THE COURT: This is going to be the subject of the ruling, and you know that it's subject to a motion.

So you shouldn't be asking about it until the court has ruled.

MR. O'CONNOR: All right.

THE COURT: We'll take our noon recess at this time. I'll ask the jury to return at 1:00. You may be excused.

THE CLERK: All rise for the jurors.

(The jury was excused at 12:04 p.m.)

(The following proceedings were held in open court, outside the presence of the jury:)

THE COURT: Now, the defendant has filed a motion for leave to present evidence of Hawaiian Isles Enterprises' alleged over-reporting of income, and an offer of proof relating to the issue of constructive dividends.

I think it would be helpful for you to understand the court's position on this, to guide what you can or cannot do in this case.

First, the court will address the motion for leave to present evidence of Hawaiian Island Enterprises' alleged [112] over-reporting of income.

The defendant offers at least two reasons why he believes this evidence should be admitted:

First, the defendant alleges that the allegedly over-reported income is relevant to his lack of willfulness.

Essentially, it appears that the defendant is arguing that he lacked a willful intent to underreport his income because he allowed it to be reported by the corporation instead of on his own returns.

While this could be relevant to the issue of willfulness, the defense has not established any foundation for this evidence, by, for example, presenting evidence that the defendant believed that if his income was reported on his corporate return, he did

not report it on his – he need not report it on his individual return.

Until and unless such a foundation is laid, the court believes that any evidence of over-reporting of income by Hawaiian Island Enterprises must be excluded as irrelevant, prejudicial and confusing to the jury.

Now, the defendant also argues that the alleged over-reporting of income is relevant because the funds at issue were in fact corporate funds being used for a corporate purpose.

Even if the defendant had laid a foundation which established that the funds at issue were corporate funds being [113] used for a corporate purpose, the defendant still has not explained why it is relevant that Hawaiian Island Enterprises over-reported those funds.

In other words, if the defendant plans to offer a defense that the funds were not income to him because he was using them for corporate purposes, it is not relevant to whether or not the corporation over-reported, under-reported, or failed to report those funds.

All that is relevant to that defense is that the funds were never income to Mr. Boulware because they could be used only for corporate purposes.

Defendant goes on to argue that he did not report the funds because he believed the funds were corporate funds being used for corporate purposes.

This argument simply appears to repeat the same argument that the defendant already made relating to his lack of willfulness, which this court has already addressed.

Now, as the court has already explained, if the defendant plans to argue that he did not believe that he was required to report the funds because they had been – already been reported by the corporation, he must lay a proper foundation, by, for example, testifying that he believed just that.

In the absence of such a foundation, the evidence is prejudicial and confusing to the jury, as well as irrelevant.

[114] Accordingly, the court, without further foundation, will deny the HIE's motion for leave to present evidence of over-reporting of income.

That's subject to reconsideration if a foundation is laid.

The court will now address to the defendant's offer of proof relating to the issue of constructive dividends and returns of capital. Which suffers from the same lack of foundation.

As the court previously explained, the Miller decision, that states that it is not relevant whether the funds could have been classified as a return of capital or a dividend at the time when they were diverted.

There is a violation, even where the diverted funds could have qualified as a return of capital, when the taxpayer fails to properly report the money as income or record it as a return of capital on the corporate books.

That's found at Page 1214 of that decision, 545 F.2d, 1204.

The defendant's offer of proof merely indicates that the defendant would introduce expert testimony that the funds at issue could have been considered return of capital.

Not only would much of this evidence be excludable as expert legal opinion, it is plainly insufficient under the Miller case.

[115] The defendant must not show merely that the funds could have been a return of capital; he must introduce evidence showing that, at the time of the transfer, the funds were in fact a return of capital.

Based upon the defendant's offer of proof, the court cannot see any benefit in holding any additional hearing on this matter.

The offer of proof fails to satisfy the standard established in the Miller case. In fact, it is expressly contrary to that standard.

And the government's motion in limine to exclude evidence relating to constructive dividends or returns of capital is hereby granted.

Now, this may very well apply to this Hawaii tax adjustment, as well.

But did you wish to be heard on any other issue?

MR. O'CONNOR: Just to clarify, Your Honor.

THE COURT: Yeah?

MR. O'CONNOR: As I understand it, the court is ruling on the over-payment of taxes by the company. Is that correct?

THE COURT: That's right.

MR. O'CONNOR: The court –

THE COURT: Because you filed a motion offering evidence of over-payment –

[116] MR. O'CONNOR: Over-payment.

THE COURT: – of income, and an offer of proof relating to the issue of constructive dividends.

MR. O'CONNOR: A little while ago –

THE COURT: I am ruling on your motion and denying it.

MR. O'CONNOR: Yes, Your Honor.

The question is –

THE COURT: I shouldn't have to explain it.

MR. O'CONNOR: The question is: Can we put on evidence of payment of taxes –

THE COURT: No.

MR. O'CONNOR: – by HIE?

Not over-payment. But the fact that they paid taxes on –

THE COURT: How is that any different than the over-reporting of taxes?

But why is it relevant? It's two different taxpayers. Your client is an individual taxpayer; the corporation is a separate taxpayer.

MR. O'CONNOR: Well, its relevant –

THE COURT: One ordinarily does not affect the other, unless there's a foundation laid to show that it should.

MR. O'CONNOR: We already have testimony in this [117] case from the accountant for the company that taxes were paid by the company. The taxes on this over-the-counter stuff and so forth, that taxes were paid by the company.

THE COURT: What's missing is the relationship to the issue of willfulness of this information. That is, no evidence that the defendant had knowledge of this, that it was a contemporaneous reaction and not contrived after the fact.

Which many of these things appear to be, contrived after the fact, to fit the case.

And that's what's missing.

MR. O'CONNOR: That's why it's important that this witness be allowed to testify about these entries that he made.

Because the entries that he made demonstrating that the company paid taxes on this –

THE COURT: Well, then, you have misunderstood the court's ruling.

This witness will not be allowed to testify and any subject . discussed. Which is –

MR. O'CONNOR: How about –

THE COURT: – which is the subject of your motion.

MR. O'CONNOR: He made these entries in 1989. Which was years before the IRS started any investigation or anything of that nature.

And therefore, the entries, although the court may [118] be correct in saying that they should not be admitted for over-payment, but the fact that the entries were made in 1989, and the fact that they reflected payment of taxes on the material that we're talking about, we should certainly be allowed to put that in on willfulness.

THE COURT: Do you wish to be heard on that?

MR. DWYER: Your Honor, I think your ruling was, without the foundation, we don't get to this for purposes of willfulness.

And I think – I don't understand why this witness should be asked about something without the necessary foundation.

THE COURT: Well, that's correct. I think the witness is covered by this, as well. There should be no evidence of that without the proper foundation that I mentioned.

Anything else?

MR. O'CONNOR: Yeah. The testimony will be, Your Honor, that the defendant, Michael Boulware, told the witness to –

THE COURT: Well, that testimony would not be admissible. What the defendant told somebody else is not admissible. Clearly hearsay in every criminal case.

There has not been as much objection here as there should be about what Mr. Boulware said. That's clearly [119] hearsay.

MR. O'CONNOR: It does go to willfulness.

THE COURT: All right.

We will reconvene at 1:00.

THE CLERK: All rise.

This court will be in recess until 1:00 p.m. (The lunch recess was taken at 12:15 p.m.)

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff,	) CRIMINAL NO. 99-00239ER
vs.	)
MICHAEL H. BOULWARE, Defendant.	) - VOLUME 9 -

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Tuesday, July 12, 2005, at 9:13 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

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* * *

[126] A. When I bought greens?

Q. Green beans in Kona.

A. That would go directly to the company.

Q. Okay.

Getting back to the use of cash.

How much were you spending, say on a yearly basis, in cash in Kona to buy coffee in those days, '90, '91, '92?

A. It's hard to say. Maybe a little slower, maybe a little higher. Maybe about a little over $2 million.

Q. A year?

A. No. I don't think so.

Q. How much a year?

A. Maybe $600,000, average.

Q. So for that total period of time, you're looking at about 2 million bucks?

A. Yes.

Q. In that time frame, who was buying coffee for Hawaiian Isles in Kona, say from '90 to '94?

A. That was Kona Sunrise Farms. Sheila. And Marvin.

Q. When you bought through her, did you pay in cash?

A. I think some. Some. But she was the bigger ones.

Q. But, primarily, how did you pay her for the coffee?

A. Checks that I got loans from the company or I borrowed from my ex-wife.

Q. You told us about Marvin Fukumitsu.

[127] A. Yes.

Q. Did you buy through him?

A. Yeah. He was doing the buying up there.

Q. And how about you?

A. Only initially.

Q. Okay.

When you went to buy, you were doing it in cash?

A. Well, yeah.

Q. And Fukumitsu, what was he using?

A. Cash.

Q. And did there come a time when you didn't have to pay cash anymore? To the farmers.

A. Yeah.

Q. What happened?

A. Well . . . When was that? I think was '94? '93?

The police, I think, wanted – the police wanted all the processors to stop paying cash.

Q. What police?

A. The police in Kona.

Because there was too much drugs. So they were stealing the parchments, the greens, the cherries. So they stopped that.

Q. So what did the police do about the cash payments?

A. They asked the processors to stop paying in cash.

Q. And did you stop paying in cash?

[128] A. Yes.

Q. By that time, had you developed a reputation in Kona for buying coffee?

A. Yes.

Q. And what did you believe your reputation to be?

A. That we kind of held up the whole Kona industry. Because when we first went in, coffee was going for about 75 cents a pound, cherry. And when we got through, it was at about $1.00, $1.25, $1.50.

Q. And you're still buying up there, are you not?

A. Yes.

Q. And what today is the price of coffee in Kona?

A. This year has been a bad year. It was in low demand.

So even as of last month, we were buying cherries – not cherries – actually green beans, because we were running short, at $13 a pound. It usually would cost us $6.

So cherry's probably going for, like, $2 a pound now.

Q. As compared to what when you started?

A. 90 cents, a dollar, 85 cents.

Q. Changing the subject for a minute to water.

Did there come a time when you decided that you were going to try to enlarge into the production and selling of water?

A. Yes.

[129] Q. And what did you do?

A. Well, I presented the whole thing to the company, about this water business.

And my brother, Merwyn, and his – (incomprehensible) – they thought I was crazy, you know, bottling water.

So they kind of fought me all the way. I tell, you know what, I'll do it on my own; I'll do this on my own and show you guys, then see where we go from there.

Q. And when you say do it on your own, what does that mean?

A. I took officer loans from the corporation, you know, bought all the equipment, started the whole thing up.

I think the loans were about $1.2 million.

Q. Did you establish a plant?

A. Yeah. We built the plant, everything.

Q. Where is your water plant?

A. Its in Mapunapuna, about two blocks away from where the home office is.

Q. And, generally tell – well, specifically, what did you do first in order to get the water business going?

A. Borrowed money.

Q. And then what?

A. Then went through the whole building process, head up the marketing and all that, getting this thing off the ground.

Q. Were there employees hired for the water company?

[130] A. Yes.

Q. Who hired them?

A. I did.

Q. And what did those employees do at the water company?

A. We did two things. We did those five-gallon bottled water. Then we started in the retail market.

Q. And did you market the water throughout Honolulu?

A. Yes.

Q. In what stores today in Honolulu is your water sold?

A. Every store.

Q. What do you mean by that?

A. Well, every store except 7-Eleven.

Q. Every grocery store?

A. Grocery. Lot of golf courses. We do private labels.

Q. Do you sell water through the commissary?

A. Yes.

Q. What products does Hawaiian Isles sell through the commissary system besides the water?

A. Coffee.

Q. Anything else?

A. I got some vending machines in the military.

Q. Okay.

Has the water company been successful?

A. Well, the first two years, no. I think I lost maybe about $600,000.

[131] Q. Uh-huh.

A. But then, from then on, it's been successful.

Q. Today is it successful?

A. Yes.

Q. What has happened to the water company? What did you do with it?

A. I gave it back to the corporation.

Q. And when you gave it back to the corporation, what – were you paid for it by the corporation?

A. No.

Q. When you gave it back, did you still owe money to the corporation, officer loans, for having established it?

A. Yeah.

Q. What has happened to those loans?

A. Well, the loans are still existing, the $1.2 million. And I had to borrow the $600,000 I lost. So actually, $1.8 million, I think.

And then they did something, told me, okay, you get 30 percent more stocks or something.

Q. Okay.

Did there come a time when you sold the coffee distribution – or the coffee-buying company back to Hawaiian Isles?

A. Sold it?

Q. Or gave it back.

[132] A. Yeah.

Q. And how did that happen? What happened?

A. You know, this coffee thing is really complicated to explain, but –

But so that whole segment, I told the company, you guys go do 'em already, you know, let's get staff and all that. And so they were going to just take off.

But that one, they bought all the equipment.

Q. Who is "they"?

A. The company.

Q. From you?

A. No. I never owned the equipment.

Q. Who owned the equipment?

A. No. I never owned the equipment.

Q. Who owned the equipment?

A. The company.

Q. Who did the company buy it from?

A. You know, that same – in Brazil.

Q. Okay.

And what happened when there was a –

Was there any kind of a transfer to the company of any part of the coffee – the company?

A. Yeah. I transferred that whole operation, who to contact, who to do what.

But what really happened was I bought some land in

[133] Kona –

Q. Yes?

A. – and that's where all this processing plans was going to take place and everything.

And we planted like five acres of coffee trees – or I did – five acres of coffee trees and everything.

Then I found one heiau, you know, on the land.

Q. And what happened when you found the heiau?

A. I told the guy I bought the land from you got to take this thing back. I mean I did what I was supposed to do, blessed it, and got out.

So from that time on, the company right now just has to pick up a parcel in Kona, and all the equipment is still sitting in the Kona warehouse.

Q. Did the man you bought the land from give the – did you give the money to him?

A. Yes.

Q. Okay.

Did there come a time when HIE, Hawaiian Isles Enterprises, went into any other business besides the two that we just were talking about?

A. You mean new businesses?

Q. New businesses.

Did you try any new businesses?

A. No. Not that I can recall.

* * *

[240] commissioner on the statutory notice of deficiency.

Q. What does the $8,725 –

A. Well, that's $8 million –

Q. $8 million. I beg your pardon.

What does that represent?

A. That is the commissioner's position addressed to the so-called criminal omitted income.

The government is proposing that, in the criminal – this criminal case, that Mr. Boulware failed to report $10.2 million – or $10,215,000 – of income.

The commissioner took the position that the $1,195,000 and the $295,000, Automated Equipment and Bonded Construction amounts, should not have been taxed to Mr. Boulware; and that therefore, the remaining amount only of $8,725,000 should be the amount taxed to Mr. Boulware.

Q. All right.

Moving on. Your next item states, additional deductions by the government per indictment.

What does that mean?

A. That was simply – these were amounts simply picked up off of the indictment.

Page 2 of the computations of the government's indictment, which permitted Mr. Boulware deductions in 1993, for the cost of sale of coffee to Pele Trading and Misuzu, $359,000.

[241] The government also allowed Mr. Boulware deduction for the cost of paving – or improving the

Mokumoa Street parking lot, and the $30,000 reimbursements, or the paying of expenses of Mr. Briggs, as Mr. Briggs earlier testified.

Q. The next item reads, revised amount of monies delivered to Mr. Boulware per the government.

What does that mean?

A. Well, that's simply taking the $8,725,000 – this is the statutory notice – and further reducing it by these three items that I just described as allowance by the government in this case of deductions to Mr. Boulware.

Q. Now, your next item is, additional deductions claimed by the defendant.

Where does this information come from?

A. Well, there are two amounts there. Let me start with the top two amounts and generally describe it and give you further details.

These amounts represent the so-called unreported income for the year 1993.

In other words, the corporation was thought to have – or accused of having realized taxable income, meaning over-the-counter sales and coffee sales.

And the point raised by the government is that these amounts were not included as taxable income to either the corporation or Mr. Boulware.

[242] In fact, the corporation charged Mr. Boulware with the share of the alleged income, $765,000, for that period, 1993, and charged Ms. Lee shareholder loans of $999,600, or a million dollars.

Again, the theory that is applicable here is that, if these amounts are charged to officer loans, they cannot be charged simultaneously as income. They are either one or the other.

Since they were charged as –

MR. DWYER: Objection, Your Honor. The defendant is arguing law – or, the witness is arguing law at this point.

THE COURT: That's correct.

And that is not permitted, by the order of the court.

BY MR. O'CONNOR:

Q. Directing your attention to these particular entries, $765,000 and $1 million. Where did they come from?

A. They come from the books and records of Hawaiian Isles Enterprises.

Q. Were they put in evidence in this case?

A. Well, they were charged by use of adjusting journal entries, which are in evidence in this case.

Q. All right.

Moving on. There is an item, cost of coffee sold to Pele Trading and Hawaii Misuzu. Where does that come from?

[243] A. That's a figure that is calculated.

In other words, Mr. Tsukamoto of Price Waterhouse earlier testified that they did an analysis of the cost of coffee that was sold, and they arrived at the conclusion that the cost of goods sold equalled 93 percent of the selling prices.

In this particular case, the company had claimed cost of goods sold by a similar method. It, however, claimed 75 percent of the sales price as cost of goods sold.

Therefore, reflecting a 25 percent profit margin, rather than the seven percent profit margin that Mr. Tsukamoto earlier testified to.

Remember, he testified that the cost of goods sold should be 93 percent; therefore, the profits, or gross profits, should be seven percent.

In this case, the company used 25 percent as the profits.

Now, this has to be added to the earlier amount above, wherein the government allowed Mr. Boulware I believe it was $359,000 cost of goods sold for the year 1993.

And therefore –

Or $359,000; I'm sorry.

And therefore, when you add these two amounts, you will arrive at approximately $2,025,000, or thereabouts, as the total cost of goods sold for these years in question, [244] meaning '89 through '93.

Q. Turning to Page 2 of your exhibit.

A. Well, I'd like to finish up on Page 1, sir. Back to Page 1?

Q. The top of Page 2 is the same as the bottom of Page 1, is it not?

A. Yes.

And now, the $4,872,000 represents the net difference between the taxpayer, or defendant, and the government. The government's position is that $10,215,000 is taxable.

After these adjustments that I have now discussed, there was the taxpayer's contention that the amount in dispute, that could be taxable but which the defendant claims is not taxable because they are advances, but whichever the argument is, the amount in dispute is $4,872,000, for the reasons that I have described earlier.

Q. Now I direct your attention to the entry which says, properties returned by Mr. Boulware.

Why is that entry on this page?

A. Well, this is now another phase of this analysis.

And assuming that these amounts are either advances or potential taxable income, these amounts that total $6,827,000 represent properties returned to HIE.

And if they are potentially taxable, the return of [245] these properties negate the taxability, because the total amounts returned equal approximately – or excessive amounts returned – I'm sorry – equal $1,955,000.

Q. The first entry is Koloa real estate.

What does that refer to?

A. That is a piece of property that has been under discussion. That's the cost of Koloa.

That was ultimately delivered by Mr. Boulware to HIE.

Q. The second, green Kona coffee beans.

A. These were beans that were delivered by Mr. Boulware directly to HIE during the years '89 through approximately 1992.

Q. The next entry is, cost to start water company. What does that refer to?

A. That was earlier discussed as the amount that Mr. Boulware was charged as officer loans by HIE while he was in the process of starting the water company.

He was charged officer loans until such time that, of course, the water company was returned. In fact –

Or, I shouldn't say returned. It was delivered to HIE. In fact, that was done. However, the $1,205,000 was never forgiven by HIE.

So Mr. Boulware continued to owe that amount; and of course paid down these amounts as part of the pay-downs of the [246] officer loans, to arrive at the balance that was earlier testified to, of approximately $1.6 million.

Q. Your next entry has to do with Jin Sook Lee, properties returned, and to shareholder loan.

What generally does that have to do with it?

A. I'm sorry. Did you want an –

Q. Yeah. Just a brief explanation.

A. Well, that was their – it was, again, based upon the litigation, the lawsuit between Ms. Lee, HIE and Mr. Boulware.

And in the final analysis, after judgment was rendered, she returned and delivered to the trustee in bankruptcy that amount of money.

But because she was charged shareholder loans earlier – that shows up on Page 1 as $1 million – the deliveries by her of $3.3 million was reduced by the $1 million, the net difference was given credit, if you

will, as returns to HIE of HIE's properties that are here in dispute.

Q. And the reason that dollar amount is there is because of the judgment in the civil action; is that correct?

A. Yes, sir.

Q. So your total amount returned is $6,827,000?

A. Yes.

Q. And your next – your final entry says, excess amount returned. What does that mean?

A. That means that, in referring again to the earlier number [247] of $4,872,000, I said that the $4 million – that amount was in dispute. Meaning the government, $10.2 million; the taxpayer, that lower amount of $4.8 million.

But if the taxpayer owed that amount to HIE, whether it's corporate advances or potential taxable income, his delivery of these properties back to the corporation, certainly if they are advances, he's returned, fully repaid those advances; and therefore, he's fully satisfied his obligation, and there are no tax consequences there.

If there are potentially taxable amounts, then he has returned these amounts back to HIE; again, and he should therefore not be taxed.

MR. O'CONNOR: This might be a good time to break.

THE COURT: We will adjourn at this time, and reconvene at 9:00 tomorrow morning.

Hopefully – you have one more witness after this?

MR. O'CONNOR: That's correct, Your Honor.

THE COURT: Who is that?

MR. O'CONNOR: Mr. Hunsaker, our expert witness.

THE CLERK: All rise for the jurors.

(The jury was excused at 4:40 p.m.)

(The hearing in the above-entitled cause was concluded at 4:41 p.m.)

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	)	CRIMINAL NO. 99-00239ER - VOLUME 10 -

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Wednesday, July 13, 2005, at 9:05 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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Attorneys for the Defendant

* * *

[3] (The following proceedings were held in open court, outside the presence of the jury:)

THE COURT: Let the record show the court is meeting with counsel without the presence of the jury.

I just convened this to make certain that we don't have any problems.

I want to know what your next expert – what the subject of that witness' testimony is.

MR. O'CONNOR: He will testify as an expert accountant, Your Honor, regarding the accounting of the company, and will testify regarding Mr. Boulware's income, basically.

THE COURT: Well, does it relate to either that the transfers made to your client could have been dividends or return of capital?

MR. O'CONNOR: No, it does not relate to that.

THE COURT: All right.

MR. O'CONNOR: It relates to basic accounting.

THE COURT: Just basic accounting?

MR. O'CONNOR: Yes.

THE COURT: That's good. And that's what I wanted to make sure of.

MR. O'CONNOR: Yes.

* * *

[132] One's clean, and one has the cite.

The line in italics would be the added line.

THE COURT: Are you sure? This appears to be identical to ours.

MR. DWYER: It's just one line, Your Honor.

THE COURT: Where is this line? In italics?

MR. DWYER: Yes, Your Honor.

THE COURT: (Perusing document.)

I don't like the line because of the language it uses. And it would be over the heads of the jurors. And I think we're better off without it.

MR. DWYER: Very well, Your Honor.

THE COURT: You can argue that if you want.

MR. DWYER: Otherwise, Your Honor, the government has no objections.

THE COURT: All right.

How about the defendant?

MR. O'CONNOR, JR.: Your Honor, we do object to several of the proposed –

THE COURT: Well, you have written objections to numbers 11, 13 and 15, which the court has considered and modified.

MR. O'CONNOR, JR.: I understand that.

Those objections were submitted by Mr. Kaneshiro, Your Honor. So I am here arguing today –

* * *

[138] THE COURT: Well, this is not good faith. This is the reliance on the advice of counsel instruction.

You don't want that given?

(Discussion off the record between counsel.)

MR. O'CONNOR, JR.: We're on 11, Your Honor.

THE COURT: I'm on 11.

MR. O'CONNOR, JR.: Okay.

THE COURT: If you read it, it says that –

MR. O'CONNOR, JR.: Well, it starts –

THE COURT: It relates good faith in terms of relying on counsel's advice.

MR. O'CONNOR, JR.: It mixes the two, Your Honor. And we submitted a good faith instruction that didn't mix the two. We also submitted a reliance on counsel instruction.

THE COURT: All right, the objection is overruled.

MR. O'CONNOR, JR.: Thank you –

THE COURT: Do you wish to have the court give a reliance on the advice of counsel instruction? I'll withdraw it if you don't.

MR. O'CONNOR, JR.: Yes, Your Honor, we do.

THE COURT: All right.

Any other instruction?

MR. O'CONNOR, JR.: Instruction 13, Your Honor.

THE COURT: 13. This is the definition of income, [139] gross income for income tax purposes?

MR. O'CONNOR, JR.: Yes, Your Honor.

And this does follow the James case.

It's just that we had other language that we proposed concerning the definition –

THE COURT: We changed this to – we found that you were correct, that when monies are – and we changed the language to be consistent with James versus United States, which is a Supreme Court case from which this language came.

MR. O'CONNOR, JR.: I understand, Your Honor.

We are not objecting to that change. What we are saying is that there was further definition in our proposed instruction that we believe –

THE COURT: Let me see the proposed instruction.

(Perusing documents.)

I will not give this instruction.

One, it's much too lengthy.

Two, it represents an argument. It is an argumentative instruction, not a simple, neutral statement of the law. Which is what I strive for.

Therefore, I will give the one we have selected, unless you think that you will wish to argue that it is incorrect in some way.

MR. O'CONNOR, JR.: No, Your Honor, i am not arguing that the statement of the law is incorrect.

[140] I'm arguing that it's incomplete, and that ours is a more complete version. That's all, Your Honor.

THE COURT: I think this is a more neutral statement of the law.

You can argue whatever you wish, you know, about income, so long as it's consistent with that instruction.

MR. O'CONNOR, JR.: Thank you, Your Honor.

THE COURT: The next item is that the loan is not income.

Is that one you object to, 14?

MR. O'CONNOR, JR.: Well, the objection, Your Honor, was –

THE COURT: Do you object to 14?

MR. O'CONNOR, JR.: Yes, Your Honor.

THE COURT: All right. What is the objection?

MR. O'CONNOR, JR.: The objection is that the factors that are put forth in this instruction are not exclusive.

THE COURT: They're not what?

MR. O'CONNOR, JR.: We believe that there should be language in this instruction that these factors are not exclusive . . .

(Discussion off the record between counsel.)

MR. O'CONNOR, JR.: No objection, Your Honor.

THE COURT: That language is in there, is it not?

[141] MR. O'CONNOR, JR.: I see it. I didn't see it earlier. I apologize, Your Honor.

THE COURT: Any others?

MR. O'CONNOR, JR.: Instruction 15, Your Honor.

THE COURT: Now, this is the one you filed written objections to.

And this basically adopts the language largely from the case of United States versus Hall. Which is a Ninth Circuit case.

You objected to the proposed instruction on the ground that it did not discuss the requirement that the government find the defendant's initial cash on hand.

Ordinarily, that is required. Because the deposits may include cash earned in prior years.

However, Agent Yamachika testified he did not include any cash deposits in his analysis.

Thus, there is no risk that the government's analysis includes cash deposits of funds legitimately earned in prior years.

And in addition, the Ninth Circuit has held that the government need not establish initial cash on hand where cash deposits were not considered. This was in an unpublished case, but they have done that.

So we have included language to the effect in the instruction itself. Although –

* * *

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA,	)	CRIMINAL NO. 99-00239ER
Plaintiff,	)	
vs.	)	– VOLUME 11 –
MICHAEL H. BOULWARE,	)	
Defendant.	)	

TRANSCRIPT OF PROCEEDINGS

The above-entitled matter came on for hearing on Thursday, July 14, 2005, at 9:05 a.m., at Honolulu, Hawaii

BEFORE: THE HONORABLE
EDWARD RAFEEDIE
United States District Judge

REPORTED BY: STEPHEN B. PLATT, RMR, CRR
Official U.S. District Court Reporter

APPEARANCES: LESLIE E. OSBORNE, JR., ESQ.
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Attorneys for the Defendant

* * *

[23] whom the defendant considered competent, made a full and accurate report to that attorney of all material facts of which the defendant had the means of knowledge, and then acted strictly in accordance with the advice given by that attorney.

Whether the defendant acted in good faith for the purpose of seeking advice concerning questions about which the defendant was in doubt, and whether the defendant made a full and complete report to the attorney, and whether the defendant acted strictly in accordance with the advice received are all questions for you to determine.

Now, it's the defendant's position that the money and property that the government claims as taxable income to him were corporate assets of Hawaiian Isle Enterprises and its affiliates.

Since the money and property were corporate assets, the defendant contends they were not reportable income to him during the years in question.

It is the defendant's position that he did not knowingly and willfully attempt to evade or defeat

substantial income tax, and did not knowingly and willfully file false tax returns.

Of course, the plea of not guilty creates those issues, as well.

Mr. Boulware believed that the monies and property were accounted for as assets and/or property of the company, [24] or as officer loans.

The term "gross income" for income tax purposes consists of income from whatever source derived, including but not limited to compensation for services.

The term "taxable income" means gross income, minus any deductions allowed by law.

When monies are acquired, either lawfully or unlawfully, without consensual recognition of an obligation to repay, and without restriction on their disposition, such monies are income, even though it may still be claimed that the defendant is not entitled to retain the money, and even though he may be required to restore its equivalent.

A loan is not income.

A loan is an agreement, either express or implied, whereby one party advances money to the other, and the other agrees to repay it upon such terms as to time and rate of interest, or without interest, as the parties may agree.

Essentially, you must determine whether the parties actually intended for the funds to be repaid at the time that they were transferred.

In making this determination, the following factors may be relevant, although they are not exclusive, and no single factor is dispositive:

One, whether the promise to repay is evidenced by a note or other instrument.

* * *

United States District Court
District of Hawaii

UNITED STATES OF AMERICA	**JUDGMENT IN A CRIMINAL CASE**
v.	(Filed Oct. 27, 2005)
MICHAEL H. BOULWARE	(For Offenses Committed On or After November 1, 1987)
	Case Number: **1:99CR00239-001**
	USM Number: **87201-022**
	Dennis O'Connor, Esq. Defendant's Attorney

THE DEFENDANT:

[ ] pleaded guilty to count(s): _____.

[ ] pleaded nolo contendere to count(s) _____ which was accepted by the court.

[✓] was found guilty on count(s) 1, 2, 3, 4, 5, 6, 7, 8, 9, 10 of the Second Superseding Indictment after a plea of not guilty.

The defendant is adjudicated guilty of these offenses:

Title & Section	Nature of Offense	Offense Ended	Count

See next page.

The defendant is sentenced as provided in pages 2 through 7 of this judgment. The sentence is imposed pursuant to the Sentencing Reform Act of 1984.

[ ] The defendant has been found not guilty on count(s) _____ and is discharged as to such count(s).

[ ] Count(s) _____ (is)(are) dismissed on the motion of the United States.

It is further ordered that the defendant must notify the United States Attorney for this district within 30 days of any change of name, residence, or mailing address until all fines, restitution, costs, and special assessments imposed by this judgment are fully paid. If ordered to pay restitution, the defendant must notify the court and United States attorney of material changes in economic circumstances.

October 24, 2005
Date of Imposition of Judgment

/s/ Edward Rafeedie
Signature of Judicial Officer

EDWARD RAFEEDIE,
United States District Judge
Name & Title of Judicial Officer

OCT 26 2005
Date

ADDITIONAL COUNTS OF CONVICTION

Title & Section	Nature of Offense	Offense Ended	Count
26 U.S.C. §7206(1)	False tax return	06/08/1993	1

26 U.S.C. §7206(1)	False tax return	06/08/1993	2
26 U.S.C. §7206(1)	False tax return	06/08/1993	3
26 U.S.C. §7206(1)	False tax return	06/08/1993	4
26 U.S.C. §7206(1)	False tax return	08/15/1994	5
26 U.S.C. §7201	Tax evasion	10/15/1995	6
26 U.S.C. §7201	Tax evasion	09/30/1996	7
26 U.S.C. §7201	Tax evasion	08/07/1997	8
26 U.S.C. §7201	Tax evasion	10/14/1998	9
18 U.S.C. §371	Conspiracy to make false statement to influence a financial institution		10

IMPRISONMENT

The defendant is hereby committed to the custody of the United States Bureau of Prisons to be imprisoned for a total term of 60 MONTHS

This term consists of THIRTY SIX (36) MONTHS as to each of Counts 1, 2, 3, 4, 5 of the Second Superseding Indictment; SIXTY (60) MONTHS as to each of Counts 6, 7, 8, 9, 10 of the Second Superseding Indictment,

with all terms and counts to be served concurrently with each other.

[ ] The court makes the following recommendations to the Bureau of Prisons:

[ ] The defendant is remanded to the custody of the United States Marshal.

[ ] The defendant shall surrender to the United States Marshal for this district.

[ ] at _____ on _____ .

[ ] as notified by the United States Marshal.

[✓] The defendant shall surrender for service of sentence at the institution designated by the Bureau of Prisons:

[✓] before 2:00 p.m. on 1/5/2006 .

[ ] as notified by the United States Marshal.

[ ] as notified by the Probation or Pretrial Services Office.

RETURN

I have executed this judgment as follows:

_____

_____

_____

Defendant delivered on _____ to _____ at _____ , with a certified copy of this judgment.

UNITED STATES MARSHAL

By _____
Deputy U.S. Marshal

SUPERVISED RELEASE

Upon release from imprisonment, the defendant shall be on supervised release for a term of 3 YEARS.

This term consists of ONE (1) YEAR as to each of Counts 1, 2, 3, 4, 5 of the Second Superseding Indictment; THREE (3) YEARS as to each of Counts 6, 7, 8, 9, 10 of the Second Superseding Indictment, with all terms and counts to be served concurrently with each other.

The defendant must report to the probation office in the district to which the defendant is released within 72 hours of release from the custody of the Bureau of Prisons.

The defendant shall not commit another federal, state, or local crime.

The defendant shall not unlawfully possess a controlled substance. The defendant shall refrain from any unlawful use of a controlled substance. The defendant shall submit to one drug test within 15 days of commencement of supervision and at least two periodic drug tests thereafter but no more than 8 valid drug tests per month during the term of supervision.

[✓] The above drug testing condition is suspended, based on the court's determination that the defendant poses a low risk of future substance abuse. (Check, if applicable.)

[✓] The defendant shall not possess a firearm, ammunition, destructive device, or any other dangerous weapon. (Check, if applicable.)

[✓] The defendant shall cooperate in the collection of DNA as directed by the probation officer. (Check, if applicable.)

[ ] The defendant shall register with the state sex offender registration agency in the state where the defendant resides, works, or is a student, as directed by the probation officer. (Check, if applicable.)

[ ] The defendant shall participate in an approved program for domestic violence. (Check, if applicable.)

If this judgment imposes a fine or restitution, it is a condition of supervised release that the defendant pay in accordance with the Schedule of Payments sheet of this judgment.

The defendant must comply with the standard conditions that have been adopted by this court as well as with any additional conditions on the attached page.

STANDARD CONDITIONS OF SUPERVISION

1) the defendant shall not leave the judicial district without the permission of the court or probation officer;

2) the defendant shall report to the probation officer and shall submit a truthful and complete written report within the first five days of each month;

3) the defendant shall answer truthfully all inquiries by the probation officer and follow the instructions of the probation officer;

4) the defendant shall support his or her dependents and meet other family responsibilities;

5) the defendant shall work regularly at a lawful occupation, unless excused by the probation officer for schooling, training, or other acceptable reasons;

6) the defendant shall notify the probation officer ten days prior to any change in residence or employment;

7) the defendant shall refrain from excessive use of alcohol and shall not purchase, possess, use, distribute, or administer any controlled substance or any paraphernalia related to any controlled substances, except as prescribed by a physician;

8) the defendant shall not frequent places where controlled substances are illegally sold, used, distributed, or administered;

9) the defendant shall not associate with any persons engaged in criminal activity and shall not associate with any person convicted of a felony,

unless granted permission to do so by the probation officer;

10) the defendant shall permit a probation officer to visit him or her at any time at home or elsewhere and shall permit confiscation of any contraband observed in plain view of the probation officer;

11) the defendant shall notify the probation officer within seventy-two hours of being arrested or questioned by a law enforcement officer;

12) the defendant shall not enter into any agreement to act as an informer or a special agent of a law enforcement agency without the permission of the court;

13) as directed by the probation officer, the defendant shall notify third parties of risks that may be occasioned by the defendant's criminal record or personal history or characteristics and shall permit the probation officer to make such notifications and to confirm the defendant's compliance with such notification requirement.

SPECIAL CONDITIONS OF SUPERVISION

1. That the defendant execute all financial disclosure forms, and provide the Probation Office and the Financial Litigation Unit of the U.S. Attorney's Office access to any requested financial information to include submitting to periodic debtor's examinations as directed by the Probation Office.

2. That the defendant cooperate with the Internal Revenue Service and arrange for the payment of

delinquent taxes, interest and penalties, and the timely filling of tax returns and/or corrected amended tax returns.

CRIMINAL MONETARY PENALTIES

The defendant must pay the total criminal monetary penalties under the schedule of payments on Sheet 6.

	Assessment	Fine	Restitution
Totals	$ 650.00	$ 25,000	$

[ ] The determination of restitution is deferred until ___. An *Amended Judgment in a Criminal Case* (AO245C) will be entered after such determination.

[ ] The defendant must make restitution (including community restitution) to the following payees in the amount listed below.

If the defendant makes a partial payment, each payee shall receive an approximately proportioned payment, unless specified otherwise in the priority order or percentage payment column below. However, pursuant to 18 U.S.C. §3664(i), all non-federal victims must be paid before the United States is paid.

Name of Payee	**Total Loss***	**Restitution Ordered**	**Priority or Percentage**
TOTALS	$ _____	$ _____	

[ ] Restitution amount ordered pursuant to plea agreement $ _____

[ ] The defendant must pay interest on restitution and a fine of more than $2500, unless the restitution or fine is paid in full before the fifteenth day after the date of judgment, pursuant to 18 U.S.C. § 3612(f). All of the payment options on Sheet 6 may be subject to penalties for delinquency and default, pursuant to 18 U.S.C. § 3612(g).

[ ] The court determined that the defendant does not have the ability to pay interest, and it is ordered that:

[ ] the interest requirement is waived for the [ ] fine [ ] restitution

[ ] the interest requirement for the [ ] fine [ ] restitution is modified as follows:

Payments shall be applied in the following order: (1) assessment, (2) restitution principal, (3) restitution interest, (4) fine principal, (5) fine interest, (6) community restitution, (7) penalties, and (8) costs, including cost of prosecution and court costs.

SCHEDULE OF PAYMENTS

Having assessed the defendant's ability to pay, payment of the total criminal monetary penalties are due as follows:

A [ ] Lump sum payment of $ _____ due immediately, balance due

[ ] not later than _____, or

[ ] in accordance [ ] C, [ ] D, [ ] E, or [ ] F below; or

B [✓] Payment to begin immediately (may be combined with [ ] C, [ ] D, or [ ] F below); or

C [ ] Payment in equal _____ (e.g., weekly, monthly, quarterly) installments of $ _____ over a period of _____ (e.g., months or years), to commence _ _____ (e.g., 30 or 60 days) after the date of this judgment; or

D [ ] Payment in equal _____ (e.g., weekly, monthly, quarterly) installments of $ _____ over a period of _____ (e.g., months or years), to commence _____ (e.g., 30 or 60 days) after the release from imprisonment to a term of supervision; or

E [ ] Payment during the term of supervised release will commence within _____ (e.g., 30 or 60 days) after release from imprisonment. The court will set the payment plan based on an assessment of the defendant's ability to pay at that time; or

F [ ] Special instructions regarding the payment of criminal monetary penalties:

Unless the court has expressly ordered otherwise, if this judgment imposes imprisonment, payment of criminal monetary penalties is due during imprisonment. All criminal monetary penalties, except those payments made through the Federal Bureau of Prisons' Inmate Financial Responsibility Program, are made to the Clerk of the Court.

The defendant shall receive credit for all payments previously made toward any criminal monetary penalties imposed.

[ ] Joint and Several

Defendant and Co-Defendant Names and Case Numbers (including defendant number, Total Amount, Joint and Several Amount, and corresponding pay, if appropriate.

[✓] The defendant shall pay the cost of prosecution. $10,056.14 for first trial and $8,718 for second trial, payable within 30 days of sentencing.

[ ] The defendant shall pay the following court cost(s):

[ ] The defendant shall forfeit the defendant's interest in the following property to the United States:

Payments shall be applied in the following order: (1) assessment, (2) restitution principal, (3) restitution interest, (4) fine principal, (5) fine interest, (6) community restitution, (7) penalties, and (8) costs, including cost of prosecution and court costs.

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MICHAEL H. BOULWARE

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

UNITED STATES OF AMERICA, Plaintiff, vs. MICHAEL H. BOULWARE, Defendant.	CASE NO. 99-00239-ER NOTICE OF APPEAL; CERTIFICATE OF SERVICE (Filed Nov. 02, 2005)

NOTICE OF APPEAL

NOTICE IS HEREBY GIVEN that defendant Michael H. Boulware hereby appeals to the United States Court of Appeals for the Ninth Circuit from

the Conviction and Sentence on Counts 1 through 9 and from the Sentence on Count 10 pronounced in this action on October 24, 2005.

DATED: Honolulu, Hawaii, November 2, 2005.

/s/ [Illegible]
ROBERT J. WATERS
DENNIS E. W. O'CONNOR

Attorneys for Defendant-Appellant
MICHAEL H. BOULWARE

56099

55pp

No. 06-1509

In the Supreme Court of the United States

MICHAEL H. BOULWARE, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a nontaxable return of capital up to the shareholder's stock basis, see 26 U.S.C. 301(c)(2), even if the diversion was not intended as a return of capital.

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In the Supreme Court of the United States

No. 06-1509

MICHAEL H. BOULWARE, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinions of the court of appeals (Pet. App. 1-14, 27-62) are reported at 470 F.3d 931 and 384 F.3d 794, respectively.

JURISDICTION

The judgment of the court of appeals was entered on December 13, 2006. A petition for rehearing was denied on April 23, 2007 (Pet. App. 63). The petition for a writ of certiorari was filed on May 11, 2007. The petition was granted on September 25, 2007. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant statutory provisions are set forth in an appendix to this brief. App., *infra*, 1a-10a.

STATEMENT

Following a jury trial in the United States District Court for the District of Hawaii, petitioner was convicted on five counts of willfully filing false tax returns, in violation of 26 U.S.C. 7206(1); four counts of willfully attempting to evade tax, in violation of 26 U.S.C. 7201; and one count of conspiring to make a false statement to a federally insured financial institution, in violation of 18 U.S.C. 371. The court of appeals, in a prior appeal, affirmed the conspiracy conviction but reversed the tax convictions and remanded for a new trial. Pet. App. 27-62. This Court denied a petition for a writ of certiorari. 546 U.S. 814 (2005).

On remand, petitioner was again found guilty by a jury on the tax counts, and he was sentenced to 36 months of imprisonment on the false return counts and 60 months of imprisonment on the tax evasion and conspiracy counts, to run concurrently. Pet. App. 2-3. On a second appeal, the court of appeals affirmed both the convictions and the sentence. *Id.* at 1-14.

1. a. The requirement to pay taxes is set forth in Section 1 of the Internal Revenue Code (Code), which imposes a tax on the taxable income of individuals, estates, and trusts as determined by the tables set forth in that section. 26 U.S.C. 1 (2000 & Supp. V 2005). Under Section 6151(a) of the Code, "when a return of tax is required under this title or regulations, the person required to make such return shall, without assessment or notice and demand from the Secretary, * * * pay such tax at the time and place fixed for filing the return." 26

U.S.C. 6151(a). "Every individual having for the taxable year gross income which equals or exceeds" a statutorily determined amount is obligated to file a tax return. 26 U.S.C. 6012(a)(1)(A).

Under Section 61(a) of the Code, "gross income means all income from whatever source derived." 26 U.S.C. 61(a). That includes lawful and unlawful gains, regardless of whether the taxpayer has any legal right to retain the money. *James* v. *United States*, 366 U.S. 213, 219 (1961) (plurality opinion); *Rutkin* v. *United States*, 343 U.S. 130, 136-137 (1952).

b. Under Section 7206(1) of the Code, anyone who "[w]illfully makes and subscribes any return * * * which contains * * * a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter" commits a felony punishable by a fine not more than $100,000, or imprisonment of not more than three years, or both, together with the costs of prosecution. 26 U.S.C. 7206(1). To obtain a conviction for filing false returns, the government must establish that the defendant willfully made and subscribed under penalty of perjury income tax returns that he did not believe to be true and correct as to every material matter. See *Neder* v. *United States*, 527 U.S. 1, 16 (1999); *United States* v. *Bishop*, 412 U.S. 346, 350 (1973).

Under Section 7201 of the Code, anyone who "willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof commits a felony" punishable by a fine of not more than $100,000 or imprisonment of not more than five years, or both, together with the costs of prosecution. 26 U.S.C. 7201. To support a conviction for income tax evasion, the government must prove the existence of a tax deficiency, an

affirmative act of attempted evasion of tax, and willfulness. See *Sansone* v. *United States*, 380 U.S. 343, 351 (1965).

c. Section 301(a) of the Code provides that a distribution of property "made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." 26 U.S.C. 301(a). Section 301(c) divides distributions made with respect to stock into three categories: (1) the portion that is a dividend (as defined by 26 U.S.C. 316) is taxable as ordinary income; (2) any portion that is not a dividend is treated as a return of capital up to the amount of the shareholder's basis in his stock and is nontaxable, but is "applied against and reduce[s]" the shareholder's "adjusted basis of the stock"; and (3) any amount in excess of the shareholder's basis is taxable as a capital gain. 26 U.S.C. 301(c).

Section 316 in turn defines a "dividend" as a distribution of property by a corporation to its shareholders "out of its earnings and profits." 26 U.S.C. 316(a)(2). Section 316(a) further provides, with exceptions not pertinent here, that "every distribution is made out of earnings and profits to the extent thereof." 26 U.S.C. 316(a). Read together, Section 301 and Section 316 establish that, if a corporation makes a distribution of funds to its shareholders "with respect to its stock," the tax consequences of the distribution depend, in part, on whether the corporation has earnings and profits and the amount of the shareholder's adjusted stock basis.

2. Petitioner is the founder, former president, and 50% owner of a closely held corporation, Hawaiian Isles Enterprises (HIE), that deals in tobacco distribution, coffee processing and sales, arcade games, vending machines, and bottled water. Pet. App. 2. A trust for the

benefit of petitioner's son owns the other 50% of HIE stock. J.A. 82-83, 86-88, 133. Following a six-year investigation, the Internal Revenue Service (IRS) determined that, during the period from 1989 to 1997, petitioner had diverted more than $10 million from HIE and failed to report those funds on his personal income tax returns and to pay taxes on that income, and that he had used fraudulent invoices in applying for a bank loan. The scheme to divert money from HIE involved a variety of devices. Petitioner diverted some of the funds by giving HIE checks to friends and employees and instructing them to cash the checks and then return the cash to petitioner. He diverted other funds by establishing two bank accounts in HIE's name but under petitioner's exclusive control, then depositing proceeds from HIE sales into the accounts without recording the sales on HIE's books. Petitioner also diverted HIE funds by instructing businesses that purchased coffee from HIE to remit payment directly to petitioner. In addition, petitioner used false invoices to obtain a loan from a federally insured financial institution. Pet. App. 2-3, 29-30; C.A. E.R. 334-339, 459-460, 466-467, 482, 486.

Petitioner laundered some of the diverted funds through companies in the Kingdom of Tonga and Hong Kong, and used the funds to support a lavish lifestyle, giving millions of dollars in HIE funds both to his wife and to his girlfriend. Pet. App. 2-3, 30-31; J.A. 15-17.

3. Petitioner was charged in a superseding indictment with nine counts of willfully filing false tax returns, four counts of willfully attempting to evade tax, four counts of making false statements to a federally insured financial institution, and one count of conspiracy to make such false statements. Pet. App. 29. The false return counts charged that the returns were false in that they

underreported petitioner's total income. J.A. 10-14.[1] Petitioner was convicted on five counts of filing a false tax return, four counts of tax evasion, and the conspiracy count. He was acquitted on the four counts of making false statements to a federally insured financial institution. Pet. App. 29.

4. The court of appeals affirmed petitioner's conviction on the conspiracy count, and it reversed his convictions on the tax counts and remanded for further proceedings. Pet. App. 27-62. The court reversed the tax convictions because it concluded that the district court had erred in excluding from evidence a state-court judgment that had determined, as between petitioner's girlfriend and HIE, that the funds petitioner delivered to his girlfriend belonged to HIE. *Id.* at 33-52.

The court of appeals rejected petitioner's challenge to the sufficiency of the evidence on the tax counts. Pet. App. 52-56. Petitioner contended that the government had failed to establish the existence of a tax deficiency. *Id.* at 52. He argued, *inter alia*, that the government had failed to prove that the corporate funds he diverted for his personal use did not constitute nontaxable returns of capital under 26 U.S.C. 301(c)(2). The court of appeals rejected that argument based on its decision in *United States* v. *Miller*, 545 F.2d 1204 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977), which held that the

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[1] In response to petitioner's motion for severance, the district court required the government to elect between evasion and false-return charges, where the indictment charged both offenses for the same years (*i.e.*, 1994 through 1997). As reflected in the redacted indictment (J.A. 10-18), the government chose to proceed on the evasion counts. The false return counts for 1994 through 1997 were severed and were subsequently dismissed. Pet. App. 29 n.1.

government demonstrates a deficiency once it proves that the defendant received and failed to report unexplained corporate funds. Pet. App. 54. The court of appeals also rejected petitioner's argument that, even if the government had established its case, he had "met his burden of going forward with the evidence by testifying that the diversions were loans and were accounted for as such on HIE's books." *Id.* at 56. The court concluded that there was "ample evidence" from which a rational jury could determine that the diversions were not loans and that petitioner was guilty of tax evasion and willfully submitting false tax returns. *Ibid.*

5. On retrial of the tax charges, the government's theory of the case, as originally, was that petitioner had embezzled funds from HIE by diverting millions of dollars in corporate funds to his personal benefit, and that he had failed to report those funds as income on his individual tax returns. C.A. E.R. 815-820 (closing argument). In defense, petitioner alternatively claimed that the diverted funds were nontaxable "if they are considered to be corporate advances or loans," or "if [petitioner] used the monies for corporate purposes," J.A. 97, or if they were constructively treated as a return of capital. J.A. 97-98.

The district court granted the government's motion in limine to exclude evidence offered by petitioner to establish that the diverted funds should be treated as a constructive return of capital. Pet. App. 22; see *id.* at 16-19. At a hearing, the court concluded that the government, by adducing evidence of the receipt by petitioner of unexplained funds, had demonstrated that petitioner had unreported income. *Id.* at 17. The court held that, before petitioner could rely on a return-of-capital defense, petitioner had to make "some demonstration on

the part of the taxpayer and/or the corporation that such distributions were intended to be" a return of capital. *Ibid.* (quoting *Miller*, 545 F.2d at 1215). The court noted that HIE's comptroller "ha[d] testified that there were no returns of capital during the years in question." *Id.* at 18; J.A. 46; see Pet. App. 32.

Petitioner subsequently made an offer of proof, stating, *inter alia*, that he would present expert testimony that "as the controlling shareholder, the monies could be deemed a constructive dividend or return of capital to [petitioner] which may or may not be income depending on whether or not HIE had earnings and profits for the years when the monies were obtained by [petitioner]." J.A. 97-98. The district court concluded that this offer of proof was insufficient to lay the necessary foundation for a return-of-capital defense. Pet. App. 21-22. The court observed that "it is not relevant whether the funds could have been classified as a return of capital or a dividend at the time when they were diverted." *Id.* at 21. Rather, the defendant "must introduce evidence showing that, at the time of the transfer, the funds were in fact a return of capital." *Id.* at 21-22.

At the close of the retrial, the district court instructed the jury that funds acquired "either lawfully or unlawfully, without consensual recognition of an obligation to repay, and without restriction on their disposition" are income. J.A. 174. It informed the jury of petitioner's position that the funds he received were "corporate assets" of HIE and thus "not reportable income to him," J.A. 173, and petitioner's asserted belief that the funds "were accounted for as assets and/or property of the company, or as officer loans." J.A. 174. It further instructed the jury that "[a] loan is not income," and

described the attributes of a bona fide loan. J.A. 174-175; C.A. E.R. 852-853.

The jury found petitioner guilty on four counts of tax evasion and five counts of filing a false income tax return. The district court imposed a concurrent sentence of 36 months of imprisonment on the false return counts and 60 months of imprisonment on the tax evasion and conspiracy counts. Pet. App. 2-3.

6. The court of appeals affirmed. Pet. App. 1-14. The court of appeals held that the district court had correctly construed *Miller* as requiring evidence "not merely that the funds *could* have been a return of capital, but that the funds were *in fact* a return of capital at the time of the transfer." *Id.* at 4. The court of appeals also rejected petitioner's argument that requiring a defendant to demonstrate that a distribution was in fact intended to be a return of capital "unconstitutionally shifts the burden of proof to the defendant." *Id.* at 5-6. The court held that the government had established unreported income through proof that petitioner had diverted funds from the corporation and failed to report them. Noting the lack of evidence that the funds petitioner received "were considered, intended, or recorded on the corporate records as a return of capital at the time they were made," *id.* at 6 (quoting *Miller*, 545 F.2d at 1215), the court of appeals held that the district court had correctly required petitioner to lay a foundation before allowing him to present his return-of-capital defense to the jury. *Ibid.* The court further concluded that the district court had correctly rejected petitioner's proffer as inadequate. *Ibid.*

The court of appeals acknowledged that its approach conflicted with that of the Second Circuit, which held in *United States* v. *D'Agostino*, 145 F.3d 69, 72-73 (1998),

that a taxpayer need not show that a lawful diversion of funds was intended as a return of capital when invoking the return-of-capital defense. See Pet. App. 6 (citing *D'Agostino* and *United States* v. *Bok*, 156 F.3d 157, 162 (2d Cir. 1988)). The court noted, however, that it was "by no means certain" that petitioner would prevail even under the Second Circuit's approach. *Ibid.*[2]

Judge Thomas concurred. Pet. App. 13-14. He indicated that, if he were "writing on a clean slate," he would adopt the Second Circuit's approach in *Bok* and *D'Agostino*. *Id.* at 13. He emphasized, however, that "the outcome [in this case] would not be affected" under the Second Circuit's approach, because the diversions here "may be properly considered unlawful" and because "the record indicates that [petitioner] was not the sole shareholder of HIE, which would also likely preclude him from asserting a return [of] capital defense." *Id.* at 14.

SUMMARY OF ARGUMENT

A defendant is not entitled to present a return-of-capital defense to the jury simply by asserting that he was a shareholder who diverted funds from a corporation without earnings and profits (and that he had a stock basis at least equal to the diverted amount). For the diverted funds to be a return of capital, they must have been a distribution "with respect to [the corporation's] stock," and the question whether the diverted

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[2] The court of appeals also rejected, *inter alia*, petitioner's attempt to renew his argument, which it had rejected on his first appeal, that the state-court judgment conclusively established that the funds he transferred to his girlfriend were the property of HIE. Pet. App. 11-12. Petitioner raised that issue in his petition for a writ of certiorari, Pet. i, 7-11, but this Court did not grant review of that question.

funds were such a distribution turns on the parties' intent, as objectively manifested by all of the facts and circumstances.

A. The text of Section 301 of the Internal Revenue Code requires that a payment to a shareholder be a distribution by the corporation "with respect to its stock" in order for the payment to be treated as a return of capital under Section 301. 26 U.S.C. 301(a) and (c). The ordinary meaning of the phrase "with respect to its stock" limits return-of-capital treatment to payments that are made to a shareholder *by reason of* his status as such. Accordingly, a diversion of funds from a corporation that lacks earnings and profits to a shareholder who has a sufficient basis in his stock to cover the diversion is not automatically a nontaxable return of capital. Rather, before a corporate payment receives the tax treatment in Section 301, the payment must meet the threshold requirement of having been a distribution "with respect to [the corporation's] stock."

Whether a corporate payment meets that requirement turns on all the facts and circumstances of the case. A payment does not qualify for treatment under Section 301 if the shareholder has received the funds in some capacity other than his capacity as shareholder, for example, as an employee, creditor, or embezzler. In the context here, where a shareholder has taken elaborate steps to hide diverted funds that he now asserts are a nontaxable return of capital, there must be some demonstration that the funds were in fact intended to be such a return before he is entitled to have the jury consider a return-of-capital defense. Just as intent is relevant to whether a payment is made in a nonshareholder capacity, so too is it relevant to whether it was made in a shareholder capacity.

B. If petitioner were correct that any diversion to a shareholder by a corporation without earnings and profits constituted a nontaxable return of capital up to the shareholder's basis, it would be an open invitation to tax fraud. Any taxpayer who also happens to be a shareholder could divert corporate assets with fraudulent intent and then, years later, when his fraud is discovered, claim that the diversion was a nontaxable return of capital. And, if he is not discovered, he can, without acknowledging any previous reduction in his stock basis, subsequently take a recorded return of capital, also tax-free. Nothing in the statute sanctions such a result.

C. Requiring a defendant to adduce evidence that a diversion was intended to be a distribution with respect to stock in order to invoke a return-of-capital defense does not create a disparity between criminal and civil tax cases. In civil tax cases, just as in criminal cases, whether corporate payments were made to a shareholder "with respect to [the corporation's] stock" depends on all of the facts and circumstances, including the intent of the corporation and the parties. What evidence is necessary to demonstrate that a payment was with respect to stock may vary with the circumstances, and a court may conclude that the purported intent of the corporation or shareholder was not consistent with the economic substance of the transaction. But that does not mean, as petitioner contends, that intent is not relevant; rather, actual intent is highly relevant.

D. Moreover, the approach of the court below does not shift the burden of proof to criminal defendants. The question at issue here is not one of burden of proof, but of the legal elements of the return-of-capital defense. The government retains at all times the burden of proving the elements of tax evasion beyond a reason-

able doubt. But once the government proves an unreported receipt of funds that derive from a likely source of income, it is incumbent on the defendant to adduce some evidence suggesting that the funds were not taxable. Here, petitioner sought to adduce evidence that the funds were a nontaxable return of capital, but he proffered no evidence on the threshold requirement of that defense, namely, that he received the diverted funds by reason of his status as a shareholder.

E. In any event, petitioner cannot prevail even under a rule that any diversion to a shareholder from a corporation without earnings and profits is automatically a return of capital up to the amount of the shareholder's basis in his stock. No court has applied such an automatic rule where, as here, the shareholder unlawfully diverted the corporate funds.

ARGUMENT

THE DIVERSION OF CORPORATE FUNDS TO A SHAREHOLDER OF A CORPORATION WITHOUT EARNINGS AND PROFITS DOES NOT AUTOMATICALLY QUALIFY AS A NONTAXABLE RETURN OF CAPITAL UP TO THE SHAREHOLDER'S STOCK BASIS

An individual can divert money or property from a corporation in which he is a shareholder in various ways, including by having the corporation pay his personal expenses, by "skimming" corporate receipts without ever recording the receipts as income by the corporation, or by simply taking corporate funds. Here, the government proved that petitioner diverted approximately $10 million from the corporation in all three of those ways. Pet. App. 3; see Pet. App. 30. Those diverted funds were not reported as income by petitioner, and petitioner's failure to report that income on his per-

sonal tax return formed the basis of the counts in the indictment charging the filing of false returns and evasion of income taxes. J.A. 10-17.

Among other defenses, petitioner sought to claim that the funds were a nontaxable return of capital under Sections 301 and 316 of the Code, and thus were not required to be included in his taxable gross income. J.A. 97-98. Petitioner proffered no evidence, however, that the diversions were in fact a return of capital. Instead, he proffered expert testimony that because he was "the controlling shareholder, the monies could be deemed a constructive dividend or return of capital to [petitioner] which may or may not be income depending on whether or not [the corporation] had earnings and profits for the years when the monies were obtained by [petitioner]." J.A. 98.

Petitioner contends (*e.g.*, Br. 8, 11) that a diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a nontaxable return of capital up to the shareholder's stock basis, regardless of the reasons the shareholder received the funds. That assertion cannot be squared with the text of Section 301 and would sanction tax fraud. It could not, even if correct, justify setting aside the verdict in this case.

A. The Text Of Section 301(a) Requires Evidence That The Payments Were In Fact Distributions To The Taxpayer By Reason Of His Status As A Shareholder

1. Section 301(a) of the Code provides that "a distribution of property * * * made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." 26 U.S.C. 301(a). Under Section 301(c)(2), if a corporation in fact

makes a distribution with respect to its stock and has no earnings and profits, the distribution is treated as a nontaxable return of capital up to the amount of the shareholder's adjusted basis in his stock. 26 U.S.C. 301(c)(2); see p. 4, *supra*. Thus, if a corporation without earnings and profits makes a distribution of funds with respect to its stock, and the amount of funds received by a shareholder does not exceed that shareholder's adjusted basis in his stock, the shareholder does not have to include the amount of those funds in his taxable gross income. The shareholder's basis in the stock, however, would be reduced by the amount of the distribution. 26 U.S.C. 301(c)(2).

For the return-of-capital treatment to apply, however, the corporate payment must meet the conditions of Section 301(a). See 26 U.S.C. 301(c) (stating that its terms apply "in the case of a distribution to which subsection (a) applies"). The text of Section 301(a) requires that the corporation's payment must be a "distribution * * * with respect to its stock." 26 U.S.C. 301(a). The plain meaning of that phrase limits the applicability of Section 301's tax treatment to distributions that are made to shareholders *qua* shareholders, *i.e.*, *by reason of* the recipients' status as shareholders.

As this Court has often instructed, "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner*, 331 U.S. 1, 6 (1947); see, *e.g.*, *Hartford Underwriters Ins. Co.* v. *Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) ("[W]hen the statute's language is plain, the sole function of the courts * * * is to enforce it according to its terms," unless "the disposition required by the text is * * * absurd.") (internal quotation marks and citation omitted). In ordinary par-

lance, the phrase "with respect to" means "with reference to," "as regards," and "insofar as concerns." *Webster's Third New International Dictionary of the English Language* 1934 (1993).[3] Those definitions all suggest more than a happenstance connection. Rather, those definitions connote an act that is taken *because* of a certain connection. Applying those ordinary meanings here, the plain text of Section 301(a) requires that the distribution of property by the corporation be made to a shareholder because of his ownership of its stock.

Consistent with its ordinary meaning, the IRS has consistently interpreted Section 301 as "not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder *in his capacity as such.*" 26 C.F.R. 1.301-1(c) (2007) (emphasis added); see 26 C.F.R. 1.301-1(c) (1955) (same). The legislative history of the Internal Revenue Code of 1954, which added the phrase "with respect to its stock" to the corporate distribution provisions, likewise supports that conclusion. See S. Rep. No. 1622, 83d Cong., 2d Sess. 231 (1954) ("Subsection (a) accordingly makes clear that section 301 has applicability only to distributions of property to shareholders in their capacity as such."). Distributions made to shareholders in other capacities do not qualify. "For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301." *Ibid.*

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[3] See *The Random House Dictionary of the English Language* 1640 (2d ed. 1987) ("referring to; concerning"); *The Oxford American Dictionary and Language Guide* 853 (1999) ("regarding; in reference to; as concerns"); *Webster's New International Dictionary of the English Language* 2123 (2d ed. 1957) ("[a]s regards; with reference to; as to").

Thus, to fall within the tax treatment in Section 301, it is not enough, as petitioner suggests (Br. 11), to simply demonstrate that the corporation had no earnings and profits and that the taxpayer was a shareholder and had a sufficient basis in his stock to cover the amount of the diversions. Instead, before a corporate payment receives such treatment under Section 301(c), the payment must meet the threshold requirement of having been a "distribution * * * with respect to [the corporation's] stock," 26 U.S.C. 301(a), or, in other words, a payment by the corporation to the shareholder "in his capacity as such." 26 C.F.R. 1.301-1(c).

Accordingly, a taxpayer cannot maintain that any diversion of corporate funds by a shareholder must automatically be treated as a return of capital if the corporation lacks earnings and profits and the shareholder has a sufficient stock basis. *United States* v. *Miller*, 545 F.2d 1204, 1210-1214 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977). In *Miller*, the president and sole shareholder of a closely held corporation failed to record more than $850,000 in corporate receipts on the corporate books, falsely recording some of the receipts as loans from the defendant to the corporation. *Id.* at 1209. Over the same period, the corporation paid virtually all of the defendant's personal expenses ("from the mortgage on his home to his 'Book-of-the-Month' Club obligations"), and the defendant falsely characterized the expense payments as repayments of loans. *Ibid.* Following a bench trial, the district court found that the distributions were taxable as salary, and were not constructive corporate distributions under Section 301. *Id.* at 1212, 1215-1216.

In affirming that judgment, the court of appeals correctly concluded that a taxpayer is not entitled to treat

diverted corporate funds as a constructive return of capital merely because the corporation lacked earnings and profits and the shareholder had a basis in the stock at least equal to the diverted amount. *Miller*, 545 F.2d at 1211-1212, 1214. Rather, whether a corporate payment is such a distribution "depends on the factual circumstances involved in each case under consideration." *Ibid.*

A payment does not qualify as a distribution with respect to stock, for example, if the corporation pays an individual shareholder in his capacity as a debtor, creditor, employee, or vendee, or under other circumstances where the individual's status as a shareholder is incidental, such as embezzlement or misappropriation. In the context here, where a shareholder has taken elaborate steps to hide diverted funds that he now claims are a nontaxable return of capital, "there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be" a distribution to the shareholder in his capacity as such before the taxpayer can claim the benefit of the return-of-capital tax treatment. *Miller*, 545 F.2d at 1215; see *id.* at 1216 ("Such an effort to disguise an allegedly non-taxable event (which a return of capital would normally be) raises doubts as to any claim by the defendant that he considered them to be a return of capital."). By looking to objective evidence that the distribution was intended as a return of capital (or dividend or capital gain), rather than, for example, a payment of salary, repayment of a debt, or embezzlement, the standard adopted by the court of appeals ensures that Section

301(c) treatment applies only to distributions made "with respect to" the shareholder's ownership of stock.[4]

2. Tellingly, petitioner elides the phrase "with respect to its stock" in his initial discussion of Section 301's "return of capital rule." See Br. 10-13 & n.3. He ultimately acknowledges, however, that the phrase serves to "distinguish money that a taxpayer receives from a corporation in his capacity as a shareholder from money that he receives in some other capacity—as an employee, for example, or as a creditor." Br. 26; see Br. 27 (quoting 26 C.F.R. 1.301-1(c) and the legislative history discussed above). And petitioner accepts (Br. 28) that "the intent of the shareholder and the corporation may be significant in determining whether a payment constitutes salary, a loan repayment, or some other form of distribution in a nonshareholder capacity."

But intent is likewise relevant to whether a payment is a "distribution * * * with respect to [a corporation's] stock," 26 U.S.C. 301(a), and thus a payment "to the shareholder in his capacity as such." 26 C.F.R. 1.301-1(c). Petitioner offers no explanation why intent should be relevant to determining whether a payment was made by reason of a nonshareholder capacity, but not by reason of a shareholder capacity. Often, the questions are opposite sides of the same coin. For example, if a

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[4] *Miller* stated that its rule was applicable in criminal tax cases even though it accepted that some cases had applied different constructive distribution rules in civil cases. 545 F.2d at 1212-1215. The court expressed the view that "the application of theories established in civil tax cases to problems in criminal tax cases cannot always be made." *Id.* at 1215. In the government's view, the facts-and-circumstances test articulated in *Miller* for identifying a corporate distribution with respect to its stock applies in both civil and criminal contexts. See pp. 24-31, *infra*.

payment is recorded on the corporate books as a loan to a shareholder, but there is no evidence of a contemporaneous intent to repay, that suggests that, in reality, it was not a "loan," and that it may have been a distribution with respect to the corporation's stock. See, *e.g.*, *United States* v. *Pomponio*, 429 U.S. 10, 10, 13 & n.4 (1976) (per curiam) (defendants "caused corporations they controlled to report payments to them as loans, when they knew the payments were really taxable dividends"); *Crowley* v. *Commissioner*, 962 F.2d 1077, 1080-1085 (1st Cir. 1992) ("The determination whether the parties to the transaction actually intended a loan or a dividend presents an issue of fact."). Similarly, whether payments to a shareholder-employee were compensation or dividends turns, at least in part, on whether there was compensatory intent or an intent to make dividend distributions. See, *e.g.*, *Elliotts, Inc.* v. *Commissioner*, 716 F.2d 1241, 1244-1248 (9th Cir. 1983).[5]

Nevertheless, petitioner essentially seeks (Br. 27-30) a default rule to the effect that any diversion by a shareholder of corporate funds is a distribution "with respect to [the corporation's] stock," 26 U.S.C. 301(a), "unless there is evidence to the contrary." Br. 29. But nothing in the statute supports such a rule. Instead, Congress has set forth particular predicates for the tax treatment

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[5] The tax treatment of such funds, for both the shareholder and the corporation, depends on the nature of the payment. For example, salary is included in an individual's taxable gross income, as is embezzled money, see 26 U.S.C. 61(a); *James* v. *United States*, 366 U.S. 213, 219 (1961) (plurality opinion), whereas a bona fide loan by a corporation to a shareholder is not. See *Commissioner* v. *Tufts*, 461 U.S. 300, 307 (1983). And, although a corporation may deduct amounts that are salary (26 U.S.C. 162(a)(1); 26 C.F.R. 1.162-1(a)), or that are stolen (26 U.S.C. 165(e)), it cannot deduct distributions with respect to its stock.

provided by Sections 301 and 316, one of which is that the payment be a corporate "distribution * * * with respect to its stock." 26 U.S.C. 301(a). Unless there is evidence of a causal link to stock ownership, diversions cannot be so characterized. Moreover, petitioner omits (Br. 28-29) from his examples of evidence that would be "to the contrary" one particularly relevant way in which someone who happens to be a shareholder can receive funds in a nonshareholder capacity: embezzlement. Where, as here, a taxpayer diverts substantial funds from a corporation, "assume[s] control of the funds and then fails to report such funds as income or to make any adjustments in the corporate books to reflect a return of capital," *Miller*, 545 F.2d at 1214 n.12, there is evidence that the funds were not a distribution by the corporation "with respect to its stock," but were, for example, embezzled funds. In this context, the court of appeals was correct to require some demonstration that the distribution was "intended to be" a distribution with respect to the corporation's stock. Pet. App. 4 (citing *Miller*, 545 F.2d at 1214-1215). That is particularly true where, as here, there were efforts at concealment that would make little sense in the context of an actual nontaxabie distribution "with respect to stock."[6]

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[6] Contrary to petitioner's contention (Br. 24-25), the requirement of such a showing is not inconsistent with the fact that current earnings and profits are determined at the close of the corporation's tax year. See 26 U.S.C. 316(a)(2). A defendant can adduce evidence of the requisite intent by showing that, at the time of the diversion, there was evidence that the transfer was intended to be a corporate distribution "with respect to [the corporation's] stock," and that, at the close of the taxable year, when the amount of current earnings and profits became known, the transferred funds were treated as a dividend, return of capital, or capital gain.

B. Congressional Purpose Would Be Thwarted If Unexplained Diverted Funds Were Automatically Treated As Distributions With Respect To Stock

Petitioner's proposed interpretation of Sections 301 and 316 would thwart congressional purpose and would encourage tax fraud. Congress sought to tax all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *James* v. *United States*, 366 U.S. 213, 219 (1961) (plurality opinion) (quoting *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)). This includes lawful and unlawful gains, regardless of whether the taxpayer has any legal right to retain the money. *Ibid.* (holding, in a criminal case, that embezzled funds are taxable); *Rutkin* v. *United States*, 343 U.S. 130, 136-137 (1952) (same as to extorted funds). In addition, Congress has established a system for the collection of the income tax that relies "largely upon the taxpayer's own disclosures." *Spies* v. *United States*, 317 U.S. 492, 495 (1943). "This system can function successfully only if those within and near taxable income keep and render true accounts." *Ibid.*

Contrary to those congressional goals, the automatic return-of-capital rule advanced by petitioner would "sanction the diversion and non-reporting of corporate and personal funds." *Miller*, 545 F.2d at 1214. A shareholder of a corporation without earnings and profits could divert corporate funds to his own use (up to the amount of his stock basis) with no risk of ever paying taxes on those gains or being found criminally liable under the tax laws. Such a rule would "permit the taxpayer to divert [corporate] funds and if not caught, to later pay out another return of capital; or if caught, to avoid conviction by raising the defense that the sums

were a return of capital and hence non-taxable." *Id.* at 1215.

Moreover, petitioner's rule would create an anomaly, whereby "[a] taxpayer who diverted funds from his close corporation when it was in the midst of financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in stock) for failure to report such sums as income." *Miller*, 545 F.2d at 1214. But "that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." *Ibid.* Congress could not have intended such a result.

This case illustrates how petitioner's rule would frustrate Congress's purposes. Petitioner diverted $10 million in corporate funds, and he laundered some of those funds through companies in the Kingdom of Tonga and Hong Kong. Petitioner did not report those funds as income. If petitioner's diversions had never been uncovered, he could subsequently have recorded a return-of-capital on the corporation's books and removed still more funds from the corporation tax-free. Here, of course, petitioner's diversions were discovered. Since that discovery, he alternatively has contended that the diverted funds still belonged to the corporation (Pet. App. 34-35; J.A. 174), that the funds were used for corporate purposes (J.A. 59-60, 95), that the funds "were loans" (Pet. App. 56; J.A. 95, 174), and that the funds "could" have been returns of capital (Pet. App. 4). The jury, which was instructed on petitioner's first three claims (J.A. 174-175), necessarily rejected those characterizations. If petitioner were now able to recharacterize the payments post hoc as nontaxable returns of capital, despite the lack of *any* evidence that the payments were in fact intended to be distributions to him

because of his status as a shareholder, that would sanction not only his evasion of taxes, but also encourage others to engage in similar behavior.

C. The Approach Of The Court Below Is Consistent With Civil Tax Cases

Contrary to petitioner's assertion (Br. 15-26), the approach of the court below is consistent with the application of Section 301 in civil cases. In the civil context, as in the criminal context, a disbursement of corporate funds to a shareholder is not automatically treated as a distribution "with respect to its stock." In both contexts, whether a payment to a shareholder was because of his status as a shareholder or for some other reason turns on all of the facts and circumstances, including the intent of the corporation and the shareholder.

1. Petitioner relies (Br. 11) on the approach of the Second Circuit, but that approach stems from a faulty assumption that, in civil cases, distributions of corporate funds to a shareholder are automatically treated as distributions "with respect to [the corporation's] stock." See *United States* v. *Bok*, 156 F.3d 157, 162-163 (1998); *United States* v. *D'Agostino*, 145 F.3d 69, 72-73 (1998). In *D'Agostino*, the Second Circuit held that every distribution of funds to a shareholder from a corporation without earnings or profits qualifies as a return of capital up to the shareholder's stock basis, even if the distribution was not intended as a return of capital. 145 F.3d at 72-73; see *Bok*, 156 F.3d at 162-164 (observing that "under certain circumstances monies lawfully withdrawn from a corporation by one of its shareholders may constitute a nontaxable return of capital," but holding that the defendant failed to meet his burden of coming forward with evidence of a lack of earnings and profits).

In *D'Agostino*, shareholders in a closely held corporation diverted approximately $400,000 in corporate funds to their personal use and hid the cash in kitchen drawers. The distributions were not intended as repayments of capital; the court conceded that "[i]t is entirely possible the D'Agostinos intended to evade paying taxes." 145 F.3d at 73. Nonetheless, the court held that because the corporation did not have earnings or profits, the distributions automatically qualified as nontaxable returns of capital, up to the defendants' basis in their stock. *Id.* at 72-73.[7]

The Second Circuit considers its approach "better reasoned" because, in its view, inquiring into the intent of the corporation to make a distribution with respect to stock would "place[] greater emphasis on the intent element in criminal tax evasion cases" while "minimiz[ing] the government's burden of proving a tax deficit," and would have the anomalous result of assigning the government "a higher burden of proof in a civil tax collection matter than in a criminal tax evasion prosecution." *D'Agostino*, 145 F.3d at 73. In reaching that conclusion, however, the Second Circuit misread the Tax Court's decision in *Truesdell* v. *Commissioner*, 89 T.C. 1280 (1987), and the IRS's acquiescence in that decision, 1988-2 C.B. 1 (1988), as standing for the proposition that diverted funds in civil cases are automatically treated as

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[7] Although the defendants' stock basis did not exceed the amount that they had diverted, the Second Circuit did not treat the remaining amount as capital gain under Section 301(c)(3). Instead, the court of appeals allowed the taxpayers to treat a portion of the amount diverted as a repayment of a loan, despite the lack of any evidence that it was in fact such a repayment. *D'Agostino*, 145 F.3d at 71, 73.

distributions "with respect to [the corporation's] stock" under Section 301.[8]

Neither *Truesdell* nor the IRS's acquiescence in that decision supports such an automatic rule. In *Truesdell*, the Tax Court rejected the government's argument that diverted funds are automatically taxable as ordinary income in every case where the taxpayer exercises "dominion and control" over the funds, and that a taxpayer cannot defend on the basis that the funds were distributions with respect to stock. 89 T.C. at 1298. But the court also followed *Miller* in refusing "to apply the constructive distribution rules automatically to shareholder diversions of corporate funds." *Id.* at 1299-1300 (noting that the case was appealable to the Ninth Circuit). Having rejected the automatic rules urged by both parties, the Tax Court concluded, in its capacity as the finder of fact, that the diversions by the sole shareholder in that case were constructive dividends to the extent that the corporation had earnings and profits, concluding that "the corporation ha[d] conferred a benefit on the share-

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[8] Both *D'Agostino* and petitioner cite the acquiescence, reflected in *Truesdell*, *supra*, action on decision, 1988-25, 1988 WL 570761 (Sept. 12, 1988) (unpublished), as a proxy for the IRS's position in all civil cases. But the action on decision expressly states that it "is not to be relied upon or otherwise cited as precedent by taxpayers." *Ibid.* Further, the Internal Revenue Service Cumulative Bulletin listing the acquiescence states that "[c]aution should be exercised in extending the application of the decision to a similar case unless the facts and circumstances are substantially the same" and that "[a]cquiescence in a decision means acceptance by the Service of the conclusion reached, and does not necessarily mean acceptance and approval of any or all of the reasons assigned by the Court for its conclusions." *Cumulative List of Announcements Relating to Decisions of the Tax Court Published in the Internal Revenue Service Bulletin from January 1, 1988 Through December 31, 1988*, 1988-2 C.B. 1.

holder *in order to* distribute available earnings and profits without expectation of repayment." *Id.* at 1295 (emphasis added); see *id.* at 1293-1295, 1300.

In its memorandum recommending acquiescence in the Tax Court's decision, the IRS stated that it would no longer seek automatic application of the "dominion and control" rule with respect to wholly owned corporations. *Truesdell, supra*, action on decision, 1988-25, 1988 WL 570761 (Sept. 12, 1988) (unpublished). But it reiterated that a diversion of corporate funds cannot qualify as a constructive distribution where "the funds were additional salary or otherwise were received *in a nonshareholder capacity*." *Ibid.* (emphasis added).

In addition to *Truesdell*, the Second Circuit based its rule on its earlier decisions in *DiZenzo* v. *Commissioner*, 348 F.2d 122 (1965), and *United States* v. *Leonard*, 524 F.2d 1076 (1975), cert. denied, 425 U.S. 958 (1976). See *D'Agostino*, 145 F.3d at 72. But the *D'Agostino* holding was not required by those cases. In *Leonard*, the court did not need to decide whether the diverted funds should automatically be treated as a return of capital, because the court recognized that "[a]cceptance of this still does Leonard no good," because he had failed to satisfy his burden of producing "sufficient evidence of an absence of earnings and profits to warrant submission to the jury" of a return-of-capital defense. 524 F.2d at 1083-1084. In *DiZenzo*, the Second Circuit held that the Tax Court had erred in ruling that the corporate distribution rules could never apply to diverted corporate funds. 348 F.2d at 125. Interpreting an earlier version of the corporate-distribution provisions, the court also concluded that "no reason appears why [the funds] cannot properly be described as 'distribution(s) made by a corporation to its sharehold-

ers,'" noting that "the government ha[d] not shown that the ordinary meaning" of that language "is inadequate in this instance." *Ibid.* (quoting 26 U.S.C. 115 (1946)). But that now-superseded statutory provision did not contain the limiting phrase "with respect to its stock," and thus is not support for the *D'Agostino* rule. Compare 26 U.S.C. 115 (1946), with 26 U.S.C. 301(a); see *DiZenzo* v. *Commissioner*, 23 T.C.M. (CCH) 677, 704 n.10 (1964) (quoting 26 U.S.C. 115 (1946)), rev'd in part, 348 F.2d 122 (2d Cir. 1965).[9]

Accordingly, in civil cases just as in criminal cases, a distribution of property must have been "made by a corporation to a shareholder with respect to its stock" in order for the payments to receive dividend/return-of-capital/capital gain treatment under Section 301. 26 U.S.C. 301(a) and (c); see 26 C.F.R. 1.301-1(c). It is thus the Second Circuit's approach, not *Miller*, that departs from the ordinary rule in civil tax cases.

2. Petitioner's reliance on the "constructive dividend" cases is similarly unavailing. Petitioner points to cases in which courts have determined that corporate benefits should be treated as dividends, despite the expressed contemporaneous intent of the corporation or the taxpayer that the payments be treated otherwise. See Br. 27-28. But those cases are consistent with the approach of the court below.

For example, in *Neonatology Associates, P.A.* v. *Commissioner*, 299 F.3d 221 (3d Cir. 2002), two profes-

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[9] Petitioner also cites (Br. 12) *AJF Transportation Consultants, Inc.* v. *Commissioner*, 77 T.C.M. (CCH) 1244 (1999), aff'd, 213 F.3d 625 (2d Cir. 2000) (Table), and *DiLeo* v. *Commissioner*, 96 T.C. 858, 883-885 (1991), aff'd, 959 F.2d 16 (2d Cir.), cert. denied, 506 U.S. 868 (1992), but both of those Tax Court cases were appealable to the Second Circuit, and the Tax Court was following the Second Circuit's *DiZenzo* decision.

sional medical corporations had purchased special life insurance policies, with "artificially inflated premiums," under which an employee could access the excess funds paid by the corporations. *Id.* at 223-226, 228. In determining whether the amount of the excess contributions made by the corporations were constructive dividends (as the IRS claimed) or employer-deductible expenses or compensation (as the corporations claimed), the court considered all the factual circumstances, including the intent of the corporations and employees. It concluded that the contributions were "disguised dividends and not deductible expenses." *Id.* at 224; see *id.* at 231-233. In so doing, the court looked behind the form that the payments had taken, observing that the substance of the transaction was akin to a dividend, *id.* at 231-232, that it was "implausible" that the owners of the corporations had knowingly "overpaid substantially for term life insurance," and that only the owners of the corporations, and not non-owner employees, received the benefit. *Id.* at 229.

Petitioner's reliance (Br. 11, 22 n.8) on *Noble* v. *Commissioner*, 368 F.2d 439 (9th Cir. 1966), is misplaced for the same reason. Although the court stated that the intention of the parties is not "controlling" in determining whether corporate payments were dividends, *id.* at 443, it made that statement in rejecting the shareholders' contemporaneous treatment, as business expenses, of corporate payments "for painting and repairs on the family residence, travel expense, summer residence expenses and other items of a personal nature," *id.* at 441. Upon consideration of all the evidence, the court concluded that, despite the characterization on the corporate books, the corporation had distributed available

earnings and profits to the shareholders. *Id.* at 442-443.[10]

The cases cited by petitioner (Br. 27-28) thus do not support petitioner's claim that "[a]part from *Miller* and its progeny in the criminal context, courts do not define constructive dividends (or other distributions 'with respect to [a corporation's] stock') in terms of the intent of the corporation or the shareholder." Br. 27. To the contrary, those cases demonstrate that corporate labels are not controlling and that whether a payment by a corporation to a shareholder is a distribution "with respect to its stock" depends, just as in *Miller*, "on the factual circumstances involved in each case under consideration," including the intent of the corporation and the taxpayer. *Miller*, 545 F.2d at 1214.

What evidence is necessary to make that showing will vary according to the circumstances of the case. Where, for example, a corporation has recorded a transaction as a nonshareholder payment, but the evidence indicates that the economic substance of the transaction does not match that characterization, such evidence creates an inference that the transaction was in fact intended to be one in a shareholder capacity. While in such cases a transaction may ultimately be treated differently from the characterized intent of the corporation or the shareholder, it does not follow, as petitioner suggests (Br. 28), that actual intent is not important in de-

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[10] *Magnon* v. *Commissioner*, 73 T.C. 980 (1980), upon which petitioner also relies, is similar. See *id.* at 992-997 (rejecting shareholder's claim that corporation's performance of services on his personal property constituted bona fide loans, where there was no contemporaneous intent to repay, and concluding on all the facts, including a lack of intent that the corporation benefit from the services performed, that the services were "distributions to Magnon with respect to his stock").

termining whether a corporate diversion is "with respect to [the corporation's] stock" under Section 301(a).

The "constructive dividend" cases are consistent with the well-established principle that in determining the taxability of a transaction, courts are not bound to the form of the transaction as structured by the taxpayer; rather, courts may determine the taxability of a transaction based upon the economic substance of the transaction. See, *e.g.*, *Diedrich* v. *Commissioner*, 457 U.S. 191, 197-198 (1982); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945); *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729-731 (1929). But those cases do not suggest that form is irrelevant. This is particularly true where, as here, allowing the taxpayer to retroactively recharacterize his transaction would encourage tax fraud. Cf., *e.g.*, *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (taxpayer "must accept the tax consequences of his choice [of organization of his affairs], whether contemplated or not, * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not").

D. The Approach Of The Court Below Does Not Shift The Burden Of Proof

Petitioner contends (Br. 20-21) (quoting *D'Agostino*, 145 F.3d at 73) that the *Miller* approach "effectively eliminates proof of a tax deficiency as an element" of a Section 7201 violation, and thereby "reduces the prosecution's burden of proof." That assertion is incorrect.

It is well settled that the government's introduction of circumstantial evidence of unreported income "may transfer the burden of going forward to the defendant." *Leonard*, 524 F.2d at 1083; see, *e.g.*, *Bok*, 156 F.3d at 163

("[A] defendant does always bear the burden of production—under which the defendant must make an initial showing on each key element of the theory—to receive an instruction on the return of capital theory."); *Miller*, 545 F.2d at 1214 & n.12. As Judge Friendly noted in *Leonard*, 524 F.2d at 1083, that principle follows from this Court's decision in *Holland* v. *United States*, 348 U.S. 121 (1954). In *Holland*, the Court held that the government can establish a circumstantial case of criminal tax evasion by proving an increase in net worth that is not reflected in reported income, along with evidence supporting an inference that the increase is attributable to a likely source of income. *Id.* at 129-132, 137-138. "[T]he Government is not required to negate every possible source of nontaxable income, a matter peculiarly within the knowledge of the defendant." *Id.* at 138. Cf. *United States* v. *Massei*, 355 U.S. 595, 595 (1958) (per curiam) (holding that if "all possible sources of nontaxable income [were] negatived, there would be no necessity for proof of a likely source").

Here, the government amply met its burden. It produced evidence of $10 million in unexplained funds that petitioner had received and had not reported on his income tax returns. The government also adduced "proof of a likely source" of that income: namely, that he had diverted funds from the corporation. *Holland*, 348 U.S. at 137-138. That satisfies the government's burden of proving a deficiency. Having made that showing, the government was not required to "negative all the possible nontaxable sources" of petitioner's increase in income. *Holland*, 348 U.S. at 137. As the Court has recognized, "most assets derive from a taxable source, and * * * when this is not true the taxpayer is in a position to explain the discrepancy." *Id.* at 126. Thus, although

"the ultimate burden of persuasion remains with the government," *Leonard*, 524 F.2d at 1083, and "[t]he Government must still prove every element of the offense beyond a reasonable doubt," once the government presents an adequate case of unreported income, the defendant "remains quiet at his peril." *Holland*, 348 U.S. at 138-139.

Petitioner acknowledges these principles (Br. 16), and he does not affirmatively contest them. See NACDL Amicus Br. 9-10 (acknowledging that "a defendant may have the burden of going forward to establish no corporate earnings or profits"). Nor does he contend that the government had to prove that the diversion was not "with respect to [the corporation's] stock" as part of its case in this prosecution. *Holland* makes clear that it need not do so, until the defendant properly places that matter in issue. 348 U.S. at 138-139.

At bottom, the question here is not about the correct allocation of burdens of proof and production, but rather about the governing legal standard for the return-of-capital defense. The government agrees that it retains the ultimate burden of proving all the elements of its charges beyond a reasonable doubt. But a defendant must adduce sufficient evidence on each element of the return-of-capital defense to warrant submission of that defense to the jury. In the government's view, that defense has three elements: (1) that the diverted funds were intended to be a distribution "with respect to [the corporation's] stock," (2) that the corporation lacked earnings and profits during the relevant period, and (3) that the defendant had a basis in his stock at least equal to the amount of the diverted funds. Because petitioner proffered no evidence that the corporate diversions here were intended to be "with respect to [the cor-

poration's] stock," he did not sustain his burden of production, and the government was therefore not required to disprove his return-of-capital defense.[11]

E. Petitioner's Convictions Should Be Affirmed Even If A Lack Of Earnings And Profits, And A Sufficient Stock Basis, Are The Only Elements Of A Return-Of-Capital Defense

1. Even if the Court adopts the Second Circuit's approach, petitioner's convictions should be affirmed. The Second Circuit has qualified its "'no earnings and profits, no income' rule" by maintaining that the rule does not apply in cases "of *unlawful* diversion, such as embezzlement, theft, a violation of corporate law, or an attempt to defraud third party creditors." *D'Agostino*, 145 F.3d at 73. It repeated that note of caution in *Bok*, explaining that *D'Agostino* had "made clear" that the rule had no application in cases of unlawful diversion. 156 F.3d at 162 n.1 (citing *D'Agostino*, 145 F.3d at 73). That exception has deep roots in the civil tax cases on which the *D'Agostino* court relied. See Pet. App. 14 (Thomas, J., concurring); *Truesdell*, 89 T.C. at 1298 (emphasizing that "petitioner's diversions of income * * * were not per se unlawful" and did not appear to be "stolen, embezzled, or diverted in fraud of creditors"); *DiZenzo*, 348 F.2d at 125 (emphasizing that "[w]e are not here dealing with sums stolen or embezzled by a taxpayer" and that "[t]here has been no suggestion that the

[11] Although petitioner's proffer is insufficient on its face with respect to the other two elements as well, the government did not raise that issue in its opposition to the petition for a writ of certiorari. Nor did the government present the argument in the courts below, except when it argued in opposition to the petition for rehearing in the court of appeals that petitioner's proffer made no assertion that he had a sufficient stock basis to cover the amount of the diverted funds. See Opp. to Petition for Reh'g 10 (filed Feb. 6, 2007).

diversions in this case were improper as a matter of corporate law"). It also reflects the common sense notion that the concealment that is the hallmark of such efforts would make little sense in the context of *nontaxable* distributions. See *Miller*, 545 F.2d at 1216.

In this case, the diversion of corporate funds to petitioner was unlawful. See Br. in Opp. 13-18. First, petitioner was not the sole shareholder of the corporation; a trust for the benefit of petitioner's son also holds stock in the corporation. J.A. 82-83, 86-88, 133. Although petitioner introduced minutes from corporate meetings in 1990 and 1991 purporting to grant him broad authority to use corporate funds, an expert witness for the government testified at trial that those documents had been falsified. 3 Tr. 144-145, 153-155, 157, 159-160, 164. By unilaterally diverting corporate funds to himself and his girlfriend, in excess of his authority, petitioner acted to the detriment of the other shareholder and in breach of his fiduciary duties. See *D'Agostino*, 145 F.3d at 73 (indicating that the "no earnings and profits, no income" rule has no application where the diversion of corporate funds was "a violation of corporate law"); *DiZenzo*, 348 F.2d at 125 (same).[12]

Second, petitioner's pleadings in the state-court action suggest that he diverted corporate funds to his girlfriend for the purpose of preventing his wife from obtaining the portion of the corporation's assets to which she was entitled in their divorce. Pet. App. 14 (Thomas, J., concurring); see *id.* at 31-32, 34-35. Such diversions "may be properly considered unlawful." *Id.* at 14 (Thomas, J., concurring); see *D'Agostino*, 145 F.3d at 73

[12] The absence of any similar disbursements to the other shareholder also suggests that the diverted funds were not distributed to petitioner as a shareholder.

(indicating that the "no earnings and profits, no income" rule would not apply where corporate funds were diverted in "an attempt to defraud third party creditors"); *Truesdell*, 89 T.C. at 1298 (same).

2. Petitioner argues (Br. 30-34) that the relevant statutes do not admit of any exception for the unlawful diversion of corporate funds. On this view, a shareholder may steal or embezzle corporate funds but still automatically be entitled to treat the diversions for tax purposes as if they were "to a shareholder with respect to [the corporation's] stock" in any subsequent prosecution for tax evasion or civil case concerning a tax deficiency. That again exposes the flaw inherent in petitioner's argument: he ignores the "with respect to its stock" threshold in Section 301(a), claiming once again that "[t]he characterization of a diversion for tax purposes turns solely on the factors" identified in Section 301(c), namely, "the amount of earnings and profits, the shareholder's basis in the stock, and the size of the distribution." Br. 31. As noted, the "with respect to its stock" language provides a textual basis for concluding that concealed and embezzled funds were not distributed to a shareholder qua shareholder (as opposed to qua embezzler).[13]

Petitioner also argues that a remand for a retrial would be necessary on this point, on the ground that the

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[13] Contrary to petitioner's suggestion (Br. 33-34), *Drybrough* v. *Commissioner*, 238 F.2d 735 (6th Cir. 1956), does not stand for the proposition that unlawful funds are automatically entitled to the tax treatment under Section 301. That decision not only interprets the previous version of the corporate distribution statute, which did not contain the current "with respect to its stock" language, see pp. 27-28, *supra*, it also rejected the claim that the defendants had embezzled the funds. See *Drybrough*, 238 F.2d at 738.

jury did not find unlawfulness. Although the jury was not expressly instructed to find unlawfulness, a third trial is not warranted. The theory of the government's case was that petitioner had unlawfully diverted the funds from the corporation for his own personal benefit and that the funds were taxable on that basis. C.A. E.R. 815-820 (closing argument). Petitioner countered with his defenses that the funds were not taxable because they were corporate funds, or corporate advances, or loans, and the jury was instructed on those defenses. J.A. 173-175. The jury's verdict necessarily rejected those defenses and accepted the government's theory of the case. The only rational basis for the jury's judgment was a conclusion that petitioner unlawfully diverted the funds; no other lawful basis had any evidentiary support in the record.[14]

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[14] As petitioner expressly acknowledges (Br. 29), neither party contended that the $10 million was salary. No other lawful basis for the payment was suggested beyond the theories the jury rejected.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

1. 26 U.S.C. 301 provides:

Distributions of property

(a) In general

Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) Amount distributed

(1) General rule

For purposes of this section, the amount of any distribution shall be the amount of money received, plus the fair market value of the other property received.

(2) Reduction for liabilities

The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) Determination of fair market value

For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) Amount taxable

In the case of a distribution to which subsection (a) applies—

(1) Amount constituting dividend

That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis

That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis

(A) In general

Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913

That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) Basis

The basis of property received in a distribution to which subsection (a) applies shall be the fair market value of such property.

(e) Special rule for certain distributions received by 20 percent corporate shareholder

(1) In general

Except to the extent otherwise provided in regulations, solely for purposes of determining the taxable income of any 20 percent corporate shareholder (and its adjusted basis in the stock of the distributing corporation), section 312 shall be applied with respect to the distributing corporation as if it did not contain subsections (k) and (n) thereof.

(2) 20 percent corporate shareholder

For purposes of this subsection, the term "20 percent corporate shareholder" means, with respect to any distribution, any corporation which owns (directly or through the application of section 318)—

(A) stock in the corporation making the distribution possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote, or

(B) at least 20 percent of the total value of all stock of the distributing corporation (except nonvoting stock which is limited and preferred as to dividends),

but only if, but for this subsection, the distributee corporation would be entitled to a deduction under section 243, 244, or 245 with respect to such distribution.

(3) Application of section 312(n)(7) not affected

The reference in paragraph (1) to subsection (n) of section 312 shall be treated as not including a reference to paragraph (7) of such subsection.

(4) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

(f) Special rules

(1) For distributions in redemption of stock, see section 302.

(2) For distributions in complete liquidation, see part II (sec. 331 and following).

(3) For distributions in corporate organizations and reorganizations, see part III (sec. 351 and following).

2. 26 U.S.C. 316 provides:

Dividend defined

(a) General rule

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) Special rules

(1) Certain insurance company dividends

The definition in subsection (a) shall not apply to the term "dividend" as used in subchapter L in any case where the reference is to dividends of insurance companies paid to policyholders as such.

(2) Distributions by personal holding companies

(A) In the case of a corporation which—

(i) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(ii) for the taxable year in respect of which the distribution is made under section 563(b) (relat-

ing to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

(B) For purposes of subparagraph (A), the term "distribution of property" includes a distribution in complete liquidation occurring within 24 months after the adoption of a plan of liquidation, but—

(i) only to the extent of the amounts distributed to distributees other than corporate shareholders, and

(ii) only to the extent that the corporation designates such amounts as a dividend distribution and duly notifies such distributees of such designation, under regulations prescribed by the Secretary, but

(iii) not in excess of the sum of such distributees' allocable share of the undistributed personal holding company income for such year, computed without regard to this subparagraph or section 562(b).

(3) Deficiency dividend distributions by a regulated investment company or real estate investment trust

The term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) which constitutes a "deficiency dividend" as defined in section 860(f).

3. 26 U.S.C. 317 provides:

Other definitions

(a) Property

For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) Redemption of stock

For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

4. 26 U.S.C. 7201 provides:

Attempt to evade or defeat tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction

thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

5. 26 U.S.C. 7206 provides:

Fraud and false statements

Any person who—

(1) Declaration under penalties of perjury

Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

(2) Aid or assistance

Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document; or

(3) Fraudulent bonds, permits, and entries

Simulates or falsely or fraudulently executes or signs any bond, permit, entry, or other document required by the provisions of the internal revenue laws, or by any regulation made in pursuance thereof, or procures the same to be falsely or fraudulently exe-

cuted, or advises, aids in, or connives at such execution thereof; or

(4) Removal or concealment with intent to defraud

Removes, deposits, or conceals, or is concerned in removing, depositing, or concealing, any goods or commodities for or in respect whereof any tax is or shall be imposed, or any property upon which levy is authorized by section 6331, with intent to evade or defeat the assessment or collection of any tax imposed by this title; or

(5) Compromises and closing agreements

In connection with any compromise under section 7122, or offer of such compromise, or in connection with any closing agreement under section 7121, or offer to enter into any such agreement, willfully—

(A) Concealment of property

Conceals from any officer or employee of the United States any property belonging to the estate of a taxpayer or other person liable in respect of the tax, or

(B) Withholding, falsifying, and destroying records

Receives, withholds, destroys, mutilates, or falsifies any book, document, or record, or makes any false statement, relating to the estate or financial condition of the taxpayer or other person liable in respect of the tax;

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the

case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

IN THE SUPREME COURT OF THE UNITED STATES

MICHAEL H. BOULWARE,

Petitioner,

-v.-

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE NATIONAL ASSOCIATION OF CRIMINAL DEFENSE LAWYERS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED FOR REVIEW

1. Whether The Diversion of Corporate Funds to a Shareholder of the Corporation, Without Earnings and Profits, Automatically Qualifies As a Non-Taxable Return of Capital Up to the Shareholder's Stock Basis Even If the Diversion Was Not intended As A Return of Capital.

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This *Amicus Curiae* Brief is submitted in support of the position of the Petitioner, Michael H. Boulware. Written consents of the parties to the filing of this Brief have been contemporaneously submitted to the Clerk of the Court.[1]

INTEREST OF *AMICUS CURIAE*

The National Association of Criminal Defense Lawyers (NACDL) is a non-profit corporation whose membership is comprised of almost 10,000 lawyers and 28,000 affiliate members representing every state, including private criminal defense attorneys, public defenders, and law professors. Members serve in positions bringing them into daily contact with the criminal justice system in the state and federal courts.

NACDL was founded in 1958 to promote criminal law research, to advance and disseminate knowledge in the area of criminal practice, and to encourage integrity, independence, and expertise among criminal defense counsel. NACDL is particularly dedicated to advancing the proper, efficient, and fair administration of justice, with a focus on the role and duties of lawyers representing parties in administrative, regulatory, and criminal

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[1] As required by Rule 37.6 of this Court, *Amicus Curiae* submit the following statement: No party authorized this Brief while or in part; and no person or entity, other than *Amicus Curiae*; its members or its counsel has made a monetary contribution to the preparation or submission of this Brief.

investigations. In furtherance of this and its other objectives, NACDL files approximately 35 *amicus curiae* briefs each year, in this Court and others, addressing a wide variety of criminal justices issues.

The NACDL is the only national bar organization working on behalf of public and private defense lawyers. The American Bar Association recognizes the NACDL as an affiliated organization and awards it full representation in the ABA House of Delegates. The NACDL is dedicated to the preservation and improvement of our adversary system of justice.

The NACDL submits this Brief because it shares this Court's conviction that the due process clause of the Fifth Amendment protects the accused against conviction, except upon proof beyond a reasonable doubt of each and every element of the crime charged, including tax offenses. *In re Winship*, 397 U.S. 358, 90 S. Ct 1068, 1073 (1970), and that standard plays a "vital role" in our criminal procedure. *Id.*. at 1072. The NACDL is committed to preserving that "vital role" in this country.

SUMMARY OF THE ARGUMENT

It is NACDL's position that in the context of a criminal prosecution for tax evasion, the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a non-taxable return of capital up to the shareholders stock basis even if the diversion was originally not labeled as a return of capital. In that

connection, NACDL urges the Court to adopt the rationale of the United States Court of Appeals for the Second Circuit in *United States v. Bok,* 156 F.3d 157 (2d Cir. 1998); *United States v. D'Agostino*, 145 F.3d 69, 72 (2d Cir. 1008); and *DiZenzo v. Commissioner,* 348 F.2d 122, 125 (2d Cir. 1965). Those cases hold that money lawfully withdrawn from a corporation by one of its shareholders may constitute a non-taxable return of capital in both civil and criminal prosecutions for tax evasion provided that the corporation must not have earned a profit for the year in which the withdrawal was made.

Conversely, NACDL asks the Court to reject the holdings and rationale of *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976) and its forbearers that the return of capital analysis does not apply in criminal cases. *United States v. Miller*, at 1213, citing and relying on *Davis v. United States*, 226 F.2d 332 (6th Cir. 1955).

NACDL bases its position on several factors: first, allowing a criminal conviction under 26 U.S.C. § 7201, without proof beyond a reasonable doubt of a tax deficiency, as *Boulware* and *Miller* suggest, violates the constitutional due process requirement that a conviction requires proof beyond a reasonable doubt of all essential elements of a criminal offense. *In re Winship*, 397 U.S. 358, 364, 90 S. Ct. 1068 (1970).

Second, a plain reading of the statutory provisions, Sections 301 and 316 of Title 26 United States Code, demonstrates that when a corporation

has no earnings or profits in a given year, distributions to a shareholder "out of its earnings and profits," 26 U.S.C. § 316(a)(1), constitutes a non- taxable return of capital.

Third, the Ninth Circuit in *Boulware* relied upon a line of cases spawned by *Davis v. United States*, 226 F.2d 331 (6th Cri.1955), which was decided long before *Winship*, and which, upon analysis, compels the conclusion that *Davis* was wrongly decided. Thus, the house of cards upon which *Boulware* is constructed, including *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976), collapses.

ARGUMENT

1.THE DUE PROCESS CLAUSE OF THE FIFTH AMENDMENT TO THE CONSTITUTION COUPLED WITH THE PLAIN LANGUAGE OF THE INTERNAL REVENUE CODE SUPPORTS THE APPLICATION OF THE RETURN OF CAPITAL OR "NO INCOME NO EARNINGS RULE" OF SECTIONS 301(C)(2) AND 316(A)(1) OF THE INTERNAL REVENUE CODE TO CRIMINAL PROSECUTIONS BROUGHT PURSUANT TO TITLE 26, U.S.C. §7201.

The due process clause of the Fifth Amendment states that no person may "be deprived of life liberty or property, without due process of law. . . ." *In re Winship*, 397 U.S. 358, 90 S. Ct. 1068. *In Winship*, this Court unequivocally and explicitly held that the reasonable doubt standard of the due process clause protects an accused against

conviction; except "upon proof beyond a reasonable doubt of every fact necessary to constitute the crime with which he is charged." 90 S. Ct. at 1073. The Court based its holding on several sound principles, which are applicable in this case. These include the tenet that the reasonable doubt standard plays a vital role in the "American scheme of criminal procedure" by reducing the risk of conviction based on factual error" when a liberty interest is a stake. *Id.* at 1072.

The Court also agreed with the dissenters in the New York Court of Appeals (in the decision below in *Winship*) that "a person accused of a crime * * * would be at severe disadvantage, a disadvantage amounting to a lack of fundamental fairness, if he could be adjudged guilty and imprisoned for years on the strength of the same evidence as would suffice in a civil case. *Id.* at 1092, citing 24 N.Y.2d 196 at 205 (1969). *See e.g., United States v. Booker*, 543 U.S. 220, 230 (2005).

As Mr. Justice Frankfurter observed in *Leland v. Oregon*, 343 U.S. 790, 795, 72 S. Ct. 1002, 1005-06 (1952) "[i]t is the duty of the Government to establish * * * guilt beyond a reasonable doubt. This notion – basic in our law and rightly one of the boasts of a free society – is a requirement and safeguard of due process of law in the historic, procedural context of due process." *Id.* (72 S. Ct. at 1009 – dissenting opinion). There can be no doubt that the holding of *Winship* applies to criminal prosecutions under the I.R.C.

In *Sansone v. United States*, 380 U.S. 343, 85 S. Ct. 1004 (1965), the petitioner was convicted *inter alia,* for willfully attempting to evade his federal income taxes in violation of Section 7201 of the Internal Revenue Code of 1954 -- the same statute of which petitioner herein stands convicted. This Court, relying on *Lawn v. United States*, 355 U.S. 339, 361, 78 S. Ct. 311, 323 and *Spies v. United States*, 317 U.S. 492, 496-97, 63 S. Ct. 364, 366-67 (1958) held that the elements of Section 7201 are willfulness; *the existence of a tax deficiency,* and an affirmative act constituting an evasion or attempted evasion of tax.[2] Bad or evil intentions alone are not punishable as a crime. *United States v. D'Agostino*, 145 F.3d 69, 73 (2d Cir. 1998). Section 7201 makes clear that there must be a tax deficiency before a conviction can occur in corporate diversion cases.

Two interrelated provisions – I.R.C. Sections 301 and 316 – govern the taxation of money taken by a taxpayer from a corporation in which he owns stock. Section 301 provides in pertinent part: " ... a distribution of property . . . made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c). In turn, subsection (c)(2) provides that in a case of a distribution "a portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock." Completing the syllogism, Section 316(a) provides that "'dividend'

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[2] Title 26, United States Code, Section 7201 states:

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony.

means any distribution of property made by a corporation to its shareholders . . . *out of its earnings and profits* . . . ."

These statutes, when read together, clearly and precisely define the return of capital or no earnings and profits no income rule now firmly established, *DiZenzo v. Commissioner*, 348 F.2d 122, 125 (2d Cir. 1965), adopted by the Internal Revenue after the tax court's decision in *Truesdell v. Commissioner*, 88 T.C. 1280 (1987), and applied to criminal cases in *United States v. D'Agostino*, and *United States v. Bok*, 156 F.3d 157 (2d Cir. 1998).

In *Bok*, the Second Circuit recognized that monies lawfully withdrawn from a corporation by one of its shareholders may constitute a non-taxable return of capital. The court reasoned that if a shareholder has invested capital in a corporation and the corporation has not earned a profit for the year at issue, any monies the shareholder removed from the corporation up to his invested capital constitutes only a return of the shareholder's basis and *not* dividend income.

The holding of *United States v. Miller*, 545 F.2d 1 204 (9th Cir. 1976) and its progeny, including *United States v. Williams*, 875 F.2d 846 (11th Cir. 1989), which refused to apply the return of capital rule to criminal cases should be rejected by this Court for a number of reasons. First, *Miller* omits the element of a tax deficiency, and therefore runs afoul of *Sansone*, and the constitutional requirements of *Winship*. Second, *Boulware*, *Miller* and *Williams* hold that despite a taxpayer's

wrongful intent with respect to diverted income, as a sole shareholder of a corporation, he cannot be held *liable civilly* for a distribution that exceeds the corporation's earnings and profits and which does not exceed the shareholder's adjusted basis.

Under *Miller* and its progeny, those distributions in civil cases are considered "return of capital." *See Miller*, at 1210-12, n. 5. *Miller* and *Boulware* thus hold that a defendant may be convicted of criminal tax evasion without owing a penny in taxes. As Judge Thomas stated in his concurring opinion in *Boulware* "not only does this result indicate a logical fallacy, but is in fact a contradiction with the tax evasion requirement of the existence of a tax deficiency." *United States v. Boulware*, ___ F.3d ___, slip op at 19415 (9th Cir. 2007). *See also United States v. Leonard*, 524 F.2d 1076 (2d Cir. 1975 (Friendly, J.). In addition, the approach taken in *Miller, Williams,* and *Davis*, upon which both cases rely, effectively eliminate proof of a tax deficiency as an element of 26 U.S.C. Section 7201.

Under *Miller, Williams,* and *Davis,* the government would need prove only that the taxpayer willfully intended to exercise domain and control over the diverted funds and, through effective acts, to evade paying taxes. If Congress intended this showing to suffice, it would not have included a tax deficiency as a requisite element. This Court should also decline to adopt the *Miller-Williams* rule because those cases relied on *United States v. Davis*, 226 F.2d 331, 335-36 (6th Cir. 1955).

Davis was wrongly decided because it was based upon the assumption that any exercise of domain and control by a taxpayer over diverted funds from a corporation is an unlawful act that must be treated as ordinary income. The court in *Davis* simply refused to apply the return of capital rule in criminal tax cases. Davis' conviction was upheld simply based on his evil intent.

Similarly, the holding in *Miller* should not stand in this Court because it misconstrues the role of intent in defining a taxpayer's conduct. In return of capital cases, a taxpayer's intent is not exclusively determinative in defining the taxpayer's conduct. Under 301(c) of the I.R.C., the taxpayer or the corporation need not have contemporaneously described the distribution at issue as a dividend or return of capital at the time it was made.

Rather, as the Second Circuit in both *Bok* and *D'Agostino* recognized, "the reality of the transaction, including the amount of the shareholder's basis and the corporation's earnings or profits, as well as the amount of the distribution govern its characterization for tax purposes." *D'Agostino*, 145 F.3d at 72, 73; *Bok*, 156 F.3d at 162. Thus, in *Bok* and *D'Agostino*, the Court(s) applied a return of capital theory even though in both cases the Court(s) had little doubt that defendants therein had acted with bad intent.

Though it may be true that a defendant may have the burden of going forward to establish no corporate earnings or profits, once that proof is presented, the prosecution shoulders the burden of

proving a deficiency beyond a reasonable doubt. *See United States v. Bok,* 156 F.3d at 163.

Accordingly, the return of capital defense in criminal tax violations more closely follows the overall scheme of the I.R.C., while the subjective intent-driven rule of *Miller* and its progeny clearly frustrates the uniform application of the tax laws, and deprives criminal defendants of their right to have each and every element of the offense proved beyond a reasonable doubt.

CONCLUSION

This Court should adopt the return of capital rule in criminal cases as announced in *United States v. Bok* and *United States v. D'Agostino* and reject the holding of the Ninth Circuit in *United States v. Boulware* and its forbearers.

Dated: New York, New York
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